



# Compliance of Listed Companies with Codes of Corporate Governance and Impact on Corporate Performance: Evidence from Sri Lanka

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## 23.1 Introduction

At the beginning of the twenty-first century, fraud cases involving Enron (USA), One.Tel (Australia), WorldCom (USA), Tyco (USA), Adelphia (USA), Parmalat (Italy), Ahold (Netherlands), Notel (Canada), Satyam Computer Services (India), Golden Key (Sri Lanka), and Pramuka Bank (Sri Lanka) were corporate scandals experienced in the world. These reiterated the need for better corporate governance in the economies, and new corporate governance codes have been adopted and various researches conducted to implement this system (Tricker 2015). The corporate governance concept of the twenty-first century indicated a culture and climate of consistency, responsibility, accountability, fairness, transparency, and effectiveness deployed throughout the organization, thereby increasing organizational performance. On the other hand, various scholars have measured the impact of the concept of corporate governance on corporate performance on the basis of the agency theory and the stakeholder theory and examined it on the basis of the equilibrium variable analysis and the corporate governance index (CGI) model (Ntim 2009). Under the

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S. Dhiman, R. Samararatne (eds.), *New Horizons in Management, Leadership  
and Sustainability*, Future of Business and Finance,  
[https://doi.org/10.1007/978-3-030-62171-1\\_23](https://doi.org/10.1007/978-3-030-62171-1_23)

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CGI model, some researchers have used already established indices, while other researchers have constructed an index of their own, which renders the results of these research studies inconclusive.

The academic research in corporate governance was initiated in the early 1980s, and up to today a continuous research process is taking place (Tricker 2015). The main objective of the research in this field is to solve the problems that arose in the world based on the corporate scandals. These scandals occurred mainly due to non-compliance with corporate governance. The main inconclusive area of corporate governance research, however, is the relationship between corporate governance and corporate performance, which according to some researchers is a positive relationship between corporate governance and corporate performance (Gompers et al. 2003; Drobetz et al. 2004; Beiner et al. 2006). Corporate governance mechanisms result in improving shareholder perceptions and solving agency problems and, thus, improving corporate performance. On the other hand, some researchers (Bebchuk et al. 2009; Chhaochharia and Grinstein 2007) have shown a negative relationship between corporate governance and corporate performance. They have shown that restrictive corporate governance provisions may restrict the management as to its performance, which may lead to a reduction of corporate performance. The validity of this research is limited to small and medium firms, and its findings may vary with the size of the firm.

Sri Lankan researchers have also studied the level of corporate governance and the impact on corporate governance based on the agency theory. Heenetigala and Armstrong (2011) focused on the 2003–2007 period, when the country faced political and financial instability, using 37 companies for their research, which was conducted in economic settings different from today and using only secondary data from annual reports. Manawaduge (2012) used 60 companies and covered the 2001–2009 period and applied the CGI model to analyze the impact of corporate governance on corporate performance on an overall basis, and he conducted an in-depth investigation of the relationship of ownership concentration and corporate performance. He constructed the CGI model for his study, which was based on the Corporate Governance Code of Sri Lanka (2008), Listing Rules of the Colombo Stock Exchange (CSE) (2009), and the Organisation for Economic Co-operation and Development (OECD) Code (2004).

Sri Lanka was embroiled in an internal armed conflict from about 1980 to 2009, and the postwar economic situation (i.e., after 2009) in the country is different from that of the prewar period. In 2018, per capita gross domestic product was USD 4102, which in 2005 was only USD 1241 (Central Bank of Sri Lanka 2018). This reveals the growth of the economy and positioning of the country in the upper middle-income category in 2019 (World Bank 2019). The economic background to the corporate governance issues of the time is different from that of studies conducted in the prewar period in Sri Lanka. Furthermore, in 2017, an updated corporate governance code was introduced by the Chartered Accountants of Sri Lanka (CASL) to meet the current ongoing requirements arising from the changes taking place in the country (CASL 2017). Research conducted in other countries reveals that the impact on corporate performance has changed with time and changes in governance.

In accordance with the information discussed above, the main objective of this study is to construct a comprehensive CGI to measure corporate governance based on the overall level of compliance of listed companies in Sri Lanka with the Chartered Institute of Sri Lanka Code (2017), OECD Code (2015), and the United Kingdom (UK) Code (2016) and to examine the relationship between compliance with these corporate governance principles and the corporate performance of Sri Lankan listed companies.

The remainder of this study is organized as follows: the subsequent section discusses the theoretical perspectives of corporate governance and performance, followed by a discussion of the existing empirical literature. The next section addresses the methodology, and section 4 discusses the key findings of the study. The final section presents the conclusions and also notes the limitations of the study and future research directions.

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## **23.2 Review of Current Literature**

### **23.2.1 Theoretical Perspective of Corporate Governance and Firm Performance**

Corporate governance is vital to the management and operation of modern companies, and there is an ongoing debate about which theoretical models are appropriate (Letza et al. 2004). Furthermore, a lack of consensus on the definition of corporate governance has resulted in researchers from different backgrounds (finance, economics, sociology, and psychology) proposing different theoretical views that are all aimed at understanding the complex nature of the concept (Lawal 2012).

A number of diverse fundamental theories underlie corporate governance, including the original agency theory, stewardship theory, stakeholder theory, resource dependency theory, transaction cost theory, and political theory (Abdullah and Valentine 2009). Nevertheless, most discussions on corporate governance theories have focused on the shareholders and the stakeholders' perspectives (Letza et al. 2004; Vinten 2001). The purpose of the corporation and its associated structure of governance and arrangements are determined by two paradigms, each suggesting a different way of understanding governance (Ayuso and Argandona 2009). Consequently, this research used two theories, namely the agency theory and the stakeholder theory, to establish the relationship between corporate governance and performance in listed companies based in Sri Lanka, which are discussed next.

#### **23.2.1.1 Agency Theory**

The separation of ownership and control is one of the key features of modern corporations, and corporate governance mechanisms have become necessary to mitigate the principal-agent problem (Berle and Means 1932). The agency problem was first highlighted by Smith (1776) in the eighteenth century and explored by Ross (1973), with the first detailed description of the theory presented by Jensen and Meckling in 1976. The agency relationship is described by Jensen and Meckling (1976) as a

contract under which one or more persons (the principals) engage another person (the agent) to perform some service on their behalf, which involves delegating some decision-making authority to the agent.

Fama and Jensen (1983a, b), Williamson (1987), and Aghion and Bolton (1992) further explicated this problem over the next two decades. The agency theory evolved from the economic literature and developed along two separate streams: the positivist agency theory and the principal agent theory. The positivist agency theory describes the conflicting relationship in terms of the goals between principals and agents and explains that governance mechanisms are established to resolve these conflicts. On the other hand, the principal-agent theory discusses this relationship as a general relationship between principals and agents (Eisenhardt 1989). Both streams concern the contracting problem of self-interest as a motivator for both the principal and the agent, and they share common assumptions regarding people, organizations, and information. However, they differ in mathematical orientation, modeling effects, and constraints used (Jensen 1983). The objectives of corporate governance mechanisms are to “protect shareholder interests, minimize agency cost and ensure agent–principal interest alignment” (Davis et al. 1997, p. 23). According to Shleifer and Vishny (1997) and Kiel and Nicholson (2003), the agency theory suggests that the separation of the positions of chairman and CEO leads to higher performance. Fama (1980) contends that the appointment of nonexecutive directors to a board is designed to control management issues and is intended to have a positive effect on the firm’s performance (Fama and Jensen 1983b; Jensen and Meckling 1976). Barnhart and Rosenstein (1998) emphasized that larger boards seem to be less helpful and more difficult to coordinate, resulting in a negative effect on performance.

### **23.2.1.2 Stakeholder Theory**

The stakeholder theory has been developing continuously over the past three decades. Freeman (1984) was one of the first theorists to present the stakeholder theory as inherent in management discipline. Freeman also proposed a general theory applicable to firms based on the premise that firms should be accountable to a broad range of stakeholders (Solomon and Solomon 2004). Freeman (1984, p. VI) defines stakeholders as “any group or individual who can effect or is effected by the achievement of a corporation’s purpose.” Thus, the term stakeholder may cover a large group of participants; in fact, it applies to anyone who has a direct or indirect stake in the business (Carroll and Buchholtz 2007). Stakeholders include shareholders, employees, suppliers, customers, creditors, and communities within the vicinity of the company’s operations, in addition to the public (Solomon and Solomon 2004).

According to Clarke (2004), if corporate managers are there to maximize the total wealth of the organization, they must take into account the effects of their decisions on all stakeholders. Pesqueux and Damak-Ayadi (2005) show that the practice of stakeholder management will result in higher profitability, stability, and growth and will thus affect the firm’s performance. Consequently, good corporate governance must focus on creating a feeling of security that a company will consider

the interests of stakeholders, as the board of directors is responsible for the company as well as its stakeholders (Ljubojevic and Ljubojevic 2011). According to Jensen (2001), the stakeholder theory solves the problems caused by multiple objectives as it seeks to maximize value in the long term. Moreover, if the management of a firm does not take into account the interests of all of its stakeholders, the firm cannot be maximizing its value.

The integration of the agency and stakeholder theories stresses the special role of the company towards the shareholders and all other stakeholders. Hill and Jones (1992) proposed that the stakeholder-agency paradigm explicitly focused on the causes of conflict between managers and stakeholders. In addition, the stakeholder-agency theory highlights the concepts underlying the alignment of management and stakeholder interests in the conflict of such interests. The agency theory calls for governance mechanisms to provide sufficient monitoring or control methods to protect shareholders from conflicts of interests with agents. The stakeholder theory, however, enables fostering good relationships with a range of stakeholders and emphasizes corporate efficiency in a social context; it also underpins the corporation's purpose of maximizing shareholders' wealth. Hence, using both theories is the most effective approach, as compared to other governance theories, because it involves combining all the elements of corporate governance to improve the firm's performance. This study relies on the agency theory-stakeholder theory, which suit the nature and scope of the empirical work. Hence, the stakeholder-agency theories could provide some useful insights in the current research.

### **23.2.2 Compliance Index Model and Firm Financial Performance: Developed Countries**

The study of Gompers et al. (2003) is considered to be a pioneering study investigating the relationship between a composite corporate governance index and the firm's performance (Bauer et al. 2010). They constructed the Gompers, Ishii, and Metrick (GIM) index, consisting of 24 governance provisions extracted from the Investor Responsibility Research Centre (IRRC). Using a sample of 1500 large US firms from 1990 to 1999, Gompers et al. (2003) found that good corporate governance practices improved the firm's value, profitability, and sales growth. Subsequently, in a number of studies, the GIM index was adopted to further investigate the governance-performance relationship among US listed firms (e.g., Cremers and Nair 2005; Bhagat and Bolton 2008; Bebchuk et al. 2009). For example, Brown and Caylor (2006) found a significant and positive link between the constructed governance index and Tobin's Q among 1868 US firms.

Similarly, Bauer et al. (2010) adopted a corporate governance quotient (CGQ) index consisting of 61 provisions to examine its relationship with financial performance, using a sample of about 210 US firms from 2003 to 2005. They found a significant and positive relationship between the CGQ index and financial performance. Giroud and Mueller (2011) used the governance ratings of GIM to examine the relationship in US firms. They found out that weak corporate governance

practices lead to lower equity returns, poor operating performance, lower firm value, and lower propensity to pay dividends. Recently, Gordon et al. (2012) revealed that financial performance measured by the Q-ratio is positively related to a constructed corporate governance index in a small sample of Canadian firms. Similarly, Drobetz et al. (2004) constructed a broad corporate governance rating index (CGR) consisting of 30 governance provisions. Using a sample of 91 publicly traded German firms in 2002, they found that firms with better corporate governance showed good financial performance. In the UK, Clacher et al. (2008) found a positive relationship between the level of compliance with corporate governance and Tobin's Q/ROA in a sample of 63 firms from 2003 to 2005. To investigate this relationship, they developed a corporate governance index using the UK Combined Code (2003), which was derived from the main recommendations of the London Stock Exchange. These findings are consistent with the theoretical expectation that a high level of compliance with corporate governance standards can help reduce agency costs and increase shareholders' returns (e.g., Jensen and Meckling 1976; Shleifer and Vishny 1997).

In contrast to the findings of previous US studies reviewed above, Chhaochharia and Grinstein (2007) revealed a negative relationship between corporate governance and the firm's performance. They constructed a governance index of five main provisions to examine a sample of 312 US firms in 2001 and 2002. Similarly, Bebchuk et al. (2009) revealed a negative relationship between a composite corporate governance index (entrenchment index, hereinafter "E-index") and a firm's value. This negative relationship may imply that the costs of implementing good corporate governance practices possibly outweigh the associated benefits (see Ammann et al. 2013).

However, other studies conducted in the US and Canada suggest that there is no significant relationship between corporate governance indices and a firm's performance (e.g., Klein et al. 2005; Koehn and Ueng 2005; Epps and Cereola 2008; Daines et al. 2010). Lehn et al. (2007) used both GIM and Bebchuk, Cohen, and Ferrell's (BCF) 29 indices to examine 1500 firms in a six-year window from 1990 to 2002. They reported that there is no significant relationship between corporate governance practices and firm performance, as measured by the market-to-book ratio. Similarly, Epps and Cereola (2008) revealed no statistically significant evidence to support the correlation between the CGQ index and firms' operating performance, as measured by ROA and ROE among 230 US listed firms from 2002 to 2004. In Canada, Klein et al. (2005) and Gupta et al. (2009) used the report on business (ROB) index, and both found no evidence of overall governance mechanisms helping to improve the firm's performance. Interestingly, Daines et al. (2010) used four corporate governance indices, CGQ, Governance Metrics International (GMI), AGR, and TCL (The Corporate Library), to study a large sample of 6827 US listed firms. They revealed no significant relationship between compliance with good corporate governance practices and the firm's value.

The summary of literature related to CGI and corporate performance in developed countries is depicted in [Appendix 23.1](#).

### 23.2.3 Compliance Index Model and Firm Financial Performance: Emerging Countries

A number of studies examined the link between governance compliance indices and financial performance in emerging economies (Cheung et al. 2011; Garay and Gonzalez 2008; Price et al. 2011; Black et al. 2012; Munisi and Randøy 2013; Tariq and Abbas 2013). [Appendix 23.2](#) gives a summary of the findings of previous studies conducted in emerging countries on the relationship between composite corporate governance indices and the firm's financial performance.

Bai et al. (2004) reported a positive effect of corporate governance on the firm's value, as measured by Tobin's Q, among 1051 Chinese listed firms from 1999 to 2001. In the same context, Cheung et al. (2011) analyzed 168 large Hong Kong firms and constructed a corporate governance index based on the OECD standards and the Hong Kong Code. They found a positive governance-performance relationship using the market-to-book ratio. Similarly, Varshney et al. (2012) constructed a corporate governance index of 11 provisions using 105 Indian listed firms in 2012 and reported a positive effect of governance on performance. Haldar and Nageswara Rao (2013) also revealed that the firm's performance is positively affected by good corporate governance practices among a sample of Indian listed firms. Specifically, they studied 500 Indian firms from 2008 to 2011 using firm and market performance measures. Furthermore, Garay and Gonzalez (2008) constructed a corporate governance index of 17 provisions using 46 Venezuelan listed firms in 2004 and reported a positive effect of governance on performance.

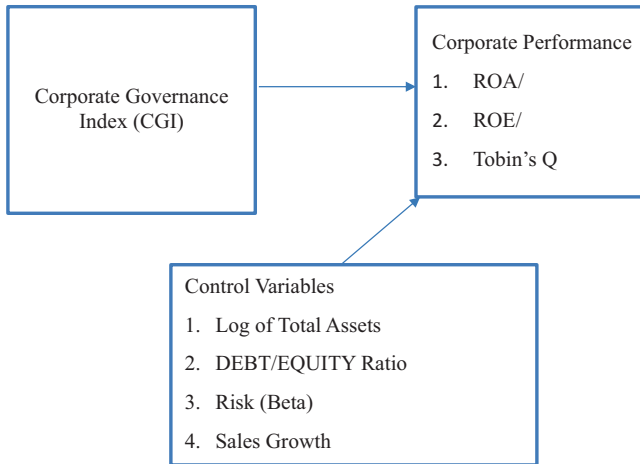
In contrast to the evidence of a positive effect of good corporate governance on the firm's performance reported in studies elaborated above in the context of developing countries, Price et al. (2011) revealed that the firm's performance is not affected by good corporate governance practices among a sample of Mexican listed firms. Specifically, they studied 107 Mexican firms from 2000 to 2004 using firm and market performance measures.

Generally, the evidence in [Appendix 23.2](#) suggests that the findings of the majority of previous studies conducted in emerging economies show a positive association with the firm's financial performance.

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## 23.3 Development of Research Hypotheses

In the Sri Lankan context, corporate governance principles are considered a vibrant element in improving a firm's performance, and the conceptual framework (see [Fig. 23.1](#)) of this study based on the extant literature establishes the link between the corporate governance elements and the firm's performance. Accordingly, the independent variable used in this study is the corporate governance index constructed with 200 elements of different corporate governance dimensions and its main sub-indexes, including elements based on the main governance principles: board of directors, transparency and disclosure, shareholders, stakeholders, and CEO and management. The dependent variables were identified as the firm's performance



**Fig. 23.1** Conceptual framework. (Source: Constructed by the authors)

proxied by Tobin's Q, return on assets (ROA), and return on equity (ROE), whereas the control variables used in this study are firm growth, leverage, firm size, and firm risk. The extant literature has established a positive relationship between superior corporate governance and financial performance (Gompers et al. 2003; Black et al. 2006), and thus the following hypothesis is established in this study:

H<sub>1</sub>: The degree of compliance with good corporate governance principles is positively associated with corporate financial performance.

Empirical evidence suggests a positive relationship between corporate governance and market performance proposed by various scholars (Brown and Caylor 2006; Garay and Gonzalez 2008). Therefore, the second hypothesis of this study is as follows:

H<sub>2</sub>: The degree of compliance with good corporate governance principles is positively associated with corporate market performance.

## 23.4 Methodology

This study is based on a positivist paradigm and therefore uses deductive reasoning and quantitative techniques, which are deemed appropriate for examining the relationship between the level of compliance and the degree of corporate financial performance. The data for the study were collected from secondary data sources, and the population consisted of public companies incorporated under the Companies Act No. 7 of 2007 (Sri Lanka) and listed in the Colombo Stock Exchange. The time period of 2009–2016 was selected because Sri Lanka has reached an upper middle-income status in 2017 (CBSL, 2019) and several corporate governance codes were introduced to meet global governance requirements during 1997 to 2017.



**Table 23.1** Sample selection

Sector	No. of companies in CSE	First sample selected	Exclusion of firms listed after 2009	Final sample	Representation from the total population
Bank finance and assurance	60	38	16	22	36.67
Beverage food and tobacco	21	14		14	66.67
Chemicals and pharmaceuticals	10	5		5	50
Construction and engineering	4	3	1	2	50
Diversified holdings	19	17	6	11	57.89
Footwear and textiles	3	0	0	0	0
Closed end	0	0	0	0	0
Health care	6	6	1	5	83.33
Hotels and travels	37	15		15	40.54
Information and technology	2	0		0	0
Investments	9	5		5	55.56
Land and property	19	7		7	36.84
Manufacturing	37	18	2	16	43.24
Motors	6	3		3	50
Oil palm	5	5		5	100
Plantations	19	5		5	26.32
Power and energy	8	5	1	4	50
Services	8	5	2	3	37.5
Store supplies	4	4		4	100
Telecommunication	2	2		2	100
Trading	8	5		5	62.5
	287	150		133	46.34

Source: Constructed by the authors

The data used cover the 2009 to 2016 period, and the stratified sampling method was applied to select firms with the sector-wise highest market capitalization as at December 31, 2016. Table 23.1 shows the sample for this study. The conceptual framework (Fig. 23.1) illustrates the link between the theoretical framework and the operationalization of the corporate governance variables and performance of the firms investigated in this study.

### Operationalization of the Variables

Table 23.2 elaborates the operationalization of the variables in this study.

**Table 23.2** Operationalization of variables

Variable and denotation	Measurement	Related studies
Corporate governance (CGI)	See <i>Note 01</i> below	
Return on equity ( <i>ROE</i> )	Net profit after tax/book value of equity	Mapitiya (2015)
Return on assets ( <i>ROA</i> )	Earnings before interest and tax/book value of assets	Price et al. (2011)
<i>Tobin's Q</i>	Market capitalization/assets' replacement cost	Black et al. (2006)
Leverage ( <i>DE</i> )	Total liabilities/total equity	Cheung et al. (2011)
Firm size ( <i>lnTA</i> )	Natural logarithm of total assets	Cheung et al. (2011)
Firm risk ( <i>Risk</i> )	Beta (covariance/variance of the stock market)	
Firm growth ( <i>Growth</i> )	Sales growth	Cheung et al. (2011)

Source: Constructed by the authors

**Table 23.3** Weights of CGI

Area	BO	SH	CEO	DI	ST	CGI
Assessor 1	45	10	20	15	10	100
Assessor 2	45	20	10	15	10	100
Assessor 3	60	10	10	10	10	100
Assessor 4	35	20	20	15	10	100
Assessor 5	90	10	0	0	0	100
Final weight assigned	275	70	60	55	40	500
CGI	55	14	12	11	8	100

Source: Constructed by the authors

*Note 1:* CGI is calculated from the information gathered from the selected sample of Sri Lankan listed companies by means of performing a structured content analysis and measures corporate governance practices in the listed companies, which consist of 200 diverse evaluation measures set as per the OECD Principles of Corporate Governance (OECD 2015), CA Sri Lanka Code (2017), and UK Code (2016). These measures are then classified into five categories, namely, responsibilities of the board of directors (*BO*), the role of stakeholders (*ST*), the role of shareholders (*SH*), disclosure and transparency (*DI*), and chief executive officer and management (*CEO*). The five main criteria were weighted according to five experts. The weights assigned by the five expert assessors are given in Table 23.3.

The weighting of marks is determined in order to allocate each of the abovementioned governance criteria according to the importance of such areas on corporate governance based on a survey conducted by research involving five professionals and academics, as detailed below, who, at the time of the survey, held the following positions:

Assessor 1 – the Chairman of Securities and Exchange Commission (SEC) Sri Lanka  
 Assessor 2 – a director of SEC

Assessor 3 – a senior academic specialized in corporate governance and finance

Assessor 4 – a director from CSE

Assessor 5 – a director from CASL

The checklist used under the structured content analysis was prepared according to the weights. Likert scale questions were prepared, and the checklist was completed based on the contents of the annual reports of the respective companies. The construction of the index was straightforward. Each attribute of the 200 items within a specified governance mechanism was scored on a scale of 0 to 5 for each checklist component, which was based on the response to the satisfactory implementation of corporate governance practice within the firm. Next, the score across all the attributes within the specific subindex were divided by the maximum possible score and multiplied by the weight. For each of the five corporate governance components (which were elaborated above), i.e., *SH*, *ST*, *DI*, *BO*, and *CEO*, subindexes were developed. The next step was calculating the mean of the scores calculated separately for each company. The scores of the index included the responses mentioned in the content analysis of annual reports regarding corporate governance. The formula below was used to calculate the CGI:

$$\text{CGI}(100) = \text{SH}(14) + \text{ST}(8) + \text{DI}(11) + \text{BO}(5) + \text{CEO}(12)$$

It was used to determine the ranking of each company, which varied according to the corporate governance score (out of 100) the company gained. These scores form the basis of the subsequent analyses.

## 23.5 Analytical Strategies

The first objective of this study was achieved by computing descriptive statistics of the governance index to measure the level of corporate governance in Sri Lanka. As explained in the preceding section, a measure of corporate governance was created by awarding weighted points for each of the principles that a company was compliant with, giving each company its own corporate governance score. This corporate governance measure was used to determine the ranking of each company as high, medium, or low based on the corporate governance score (out of 100) that the company gained. In compliance with CGI, the researchers classified the companies into four main groups, namely, low CGI (with a CGI score of 0–40), low medium CGI (with a CGI score of 40–60), upper medium CGI (60–80), and higher CGI (with a CGI score of 80–100).

Second, the impact of compliance with corporate governance practices on the firm's performance was examined using the CGI and financial and market performance. The impact was statistically verified using correlation analysis and panel regression analysis after conducting diagnosis tests and the Hausman test. The general regression equations are as follows:

$$\text{ROA} = \beta_0 + \beta_1 \text{CGI} + \beta_2 \ln \text{TA} + \beta_3 \text{DE} + \beta_4 \text{Growth} + \beta_5 \text{Risk} + \varepsilon \quad \text{Model 01}$$

$$\text{ROE} = \beta_0 + \beta_1 \text{CGI} + \beta_2 \ln \text{TA} + \beta_3 \text{DE} + \beta_4 \text{Growth} + \beta_5 \text{Risk} + \varepsilon \quad \text{Model 02}$$

$$\text{Tobin's } Q = \beta_0 + \beta_1 \text{CGI} + \beta_2 \ln \text{TA} + \beta_3 \text{DE} + \beta_4 \text{Growth} + \beta_5 \text{Risk} + \varepsilon \quad \text{Model 03}$$

## 23.6 Key Findings

According to the descriptive analysis (Table 23.4), the mean compliance level with corporate governance principles (as measured via the corporate governance index (CGI)) during the 2009 to 2016 period was 54.27%. Manawaduge (2012), in his study, found that the mean compliance level was 61.17%, and Dissabandara (2010) found that the mean compliance level of the board index was 56%. Accordingly, it is observed that the overall level of compliance is quite low and consistent with extant studies. Table 23.4 also depicts the descriptive statistics of CGI and performance variables.

According to the CGI, as reported in Table 23.5, in 2016 companies had been classified as firms with high compliance, moderate compliance, and low compliance. The main groups fall in the 20–40 range, 40–60 range, 60–80 range, and 80–100 range. In the sample, in 2016, 14 companies scored CGI values below 40 and 11 companies above 80, while most of the companies (62) scored a CGI value between 40 and 60, as shown in Table 23.5.

According to the findings of Dissabandara (2010), in the year 2008, the number of companies with low CGS scores was 10 out of 59 and corresponded to a percentage of 17%. However, based on our findings presented in Table 23.5 above, the number of low-compliance companies are 14 in the year 2016, which is 10% of the total sample. This indicates an improvement of corporate governance over time in terms of compliance.

Results of the sectoral comparison of CGI for the year 2016 are shown in Table 23.6. The highest mean of compliance level (79.845) is in the telecommunication sector. According to the empirical findings of Dissabandara (2010), the banking sector's CGI score (with board components) is highest in 2009 but is the third highest in 2016, according to this study (Table 23.6). Furthermore, the second highest CGI (68.973) is in the diversified sector, which is consistent with the findings of Dissabandara (2010). Moreover, the lowest score is observed in the service sector (27.091).

Table 23.7 indicates the extent of correlation between the overall index score and performance variables used in this study. It shows a positive relationship between

**Table 23.4** Descriptive statistics of CGI and performance variables

Variable	Mean	Skewness	Kurtosis	Minimum value	Maximum value
CGI	54.273	0.343	-0.554	32.543	78.800
CGI-SH	49.910	2.020	2.760	42.860	84.760
CGI-ST	50.570	0.060	-1.430	0.000	100.000
CGI-DI	76.520	-1.130	0.380	43.750	93.750
CGI-BO	52.960	0.700	-0.400	32.730	84.940
CGI-CEO	47.160	-0.380	-1.630	12.500	75.000
ROA	0.060	1.330	4.590	-0.030	0.230
ROE	0.130	1.320	4.630	-0.060	0.492
Tobin's Q	0.760	2.290	8.720	0.590	4.220

Source: Constructed by the authors

**Table 23.5** Classification of firms according to CGI levels in 2016

Category	CGI 2016	Mean	Obs.
	Levels		
Low	[20, 40]	34.396	14
Low medium	[40, 60]	53.069	62
Upper medium	[60, 80]	67.023	46
High	[80, 100]	83.401	11
	All	58.438	133

Source: Constructed by the authors

**Table 23.6** CGI comparison of sectors in the year 2016

Sector	Mean (2016)
Telecommunication	79.845
Diversified	68.973
Banking	65.252
Hotels	64.549
Manufacturing	62.785
Energy	61.782
Chemicals	58.93
Beverage	57.151
Investments	56.935
Motors	55.755
Plantations	54.011
Construction	53.431
Trading	47.243
Land	47.23
Health care	46.882
Oil palms	45.533
Stores	37.411
Services	27.091

Source: Constructed by the authors

CGI and the financial performance measure. The overall sample showed a statistically significant positive relationship between the CGI and ROE at the 1-percent level ( $p < 0.01$ ), indicating increased financial performance with increased compliance with corporate governance.

However, in the overall sample, Tobin's Q is negatively related to CGI, suggesting that high compliance with corporate governance causes an unexpected negative impact on market performance. Thus, it is difficult to establish a clear relationship between corporate governance and performance of Sri Lankan firms. The relationship between corporate and *financial* performance is positive, whereas it is negative for *market* performance measures.

The panel data regression analysis (Table 23.8) shows a positive relationship between the degree of compliance with corporate governance practices and company financial performance in terms of ROA and ROE, as proposed by the

**Table 23.7** Results of Pearson correlation

Variables	CGI	ROA	ROE
CGI	1		
ROA	0.020	1	
ROE	0.111**	0.710**	1
Tobin's Q	-0.130**	0.389**	0.297**

The definitions of these variables are indicated in Table 23.4

For the sample of 133 firms

\* $p < 0.05$ ; \*\* $p < 0.01$

**Table 23.8** Results of panel regression

Models	Model 01-ROA		Model 02-ROE		Model 03-Tobin's Q	
	Coefficient	Standard error	Coefficient	Standard error	Coefficient	Standard error
CGI	0.0012**	0.0004	0.0011**	0.0007	-0.0078**	0.003
Risk	0.0034	0.0026	0.0046	0.0052	0.0848**	0.0217
DE	-0.0070**	0.0015	-0.0016	0.0030	0.0136	0.0126
Growth	0.0005**	0.0001	0.0011**	0.0002	0.0025**	0.0006
lnTA	-0.0110**	0.0028	-0.0055	0.0056	-0.2584**	0.0234

The definitions of these variables are given in Table 23.4

For the sample of 133 firms

\* $p < 0.05$ ; \*\* $p < 0.01$

conceptual framework of the study. According to Table 23.8, the regressions are significant at the 95% confidence level. Since the results show a significant positive relationship between corporate governance and financial performance, hypothesis H<sub>1</sub> is supported. These results are supported by prior research on the relationship between corporate governance practices and financial performance. One of the earliest studies of the relationship of governance and performance was by Gompers et al. (2003), who found a strong positive correlation between the firms' performance and the quality of their corporate governance. Furthermore, studies such as by Okike and Turton (2009), Bauer et al. (2010), and Chang et al. (2014) found a positive relationship between corporate governance and financial performance. Also, a positive relationship between corporate governance and firm financial performance was found for emerging market studies (Bai et al. 2002; Campbell II and Keys 2002; Klapper and Love 2004; Black et al. 2003; Durnev and Kim 2005, as cited by Klein et al. 2005). Mapitiya (2015) showed that governance practices have a significant positive relationship with corporate financial performance in terms of profitability in public listed companies in Sri Lanka.

Nevertheless, market performance (i.e., measured via Tobin's Q) showed a negative relationship with corporate governance compliance (Table 23.8), which is inferred as due to the market anomalies that prevailed in the Sri Lankan market at that time. The results of the market performance are consistent with the findings of previous researches carried out based on the quality of corporate governance and firms' performance in Sri Lanka. Manawaduge (2009) specifically found out that compliance with corporate governance principles caused a negative impact on

market prices in Sri Lanka due to market anomalies. In addition to these findings, differences in compliance were noted in the industry sectors, where in certain sectors (telecommunication, diversified industry, and banking) high compliance was noted and in other sectors (service, store, and trading) a low level of compliance was observed.

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## 23.7 Conclusions and Recommendations

This study helps to fill the wide gap in the literature on corporate governance practices in Sri Lanka. Its main contribution stems from the investigation of corporate governance in Sri Lanka from a broader and more comprehensive approach where a comprehensive corporate governance index was used in this study, which was based on the CA Sri Lanka, OECD, and UK codes of corporate governance. Furthermore, this is a pioneering study to use a weighted average corporate governance index to measure compliance with corporate governance principles. This study also used a sample of 133 firms out of the 297 listed companies, which is close to half the population. Thus, this study used a relatively higher sample than in other extant studies. This investigation is also expected to contribute to knowledge of corporate governance not only in Sri Lanka but also in other developing countries.

In terms of findings, the mean compliance level of corporate governance in Sri Lanka indicated a quite low level of compliance of 54.27 (out of 100). Furthermore, it was also noted that there are significant differences among different sectors considered in this study in terms of the level of compliance. In addition, this study indicates that companies that comply with good corporate governance practices can expect to achieve better *financial* performance. These findings have significant implications and can be recommended for using good corporate governance practices across developing countries in general and in emerging countries in particular. Further, the findings provide a clear understanding of quite lower compliance levels and sectoral differences in the compliance levels in Sri Lanka and points out that policy makers, regulators, academics, the community, CA Sri Lanka, and SEC should take active steps to improve the situation. The implications for a policy from this research are expected to help policy makers and regulators identify areas of development in corporate governance that are in need of immediate attention.

The findings of the study provide extensive evidence regarding corporate governance practices and their effect on firms' performance. However, certain limitations of the study should be taken into account when considering the conclusions that can be drawn. One of the limitations of this study is that the research is based on secondary data and only considers the annual reports owing to the difficulty of obtaining primary data from 133 companies. Another limitation is that it used only two financial performance indicators (ROA and ROE) and one measure of the market (Tobin's Q) to determine company performance. Furthermore, this research covers only a seven-year period due to the nonavailability of data. Future research could examine corporate governance best practices and firms' performance over a longer period as

well as perform comparative studies among countries using a comprehensive compliance index as well as mixed methods of study.

### Chapter Takeaways

1. The level of compliance with corporate governance principles by firms could be comprehensively measured by a corporate governance index (CGI), which provides a broader picture on corporate governance. This index could include five broad subindexes: board of directors subindex, shareholders subindex, chief executive officer (CEO) and management subindex, communication and disclosure subindex, and stakeholders subindex.
2. Corporate governance and performance relationship is formulated based on various theories, including mainly the agency theory and the stakeholder theory.
3. The findings on the relationship between corporate governance and performance vary with the time period, country, industry sector, the way the variables are measured, and the data analysis method used.
4. In the context of an emerging country, the level of compliance of corporate governance has increased over time. Furthermore, sectoral differences are noted in terms of compliance levels.
5. The main findings of this study indicate that the level of compliance with corporate governance principles in Sri Lanka is quite low with sectoral differences, and the relationship between corporate governance compliance and financial performance is positive. The firms have to improve their level of compliance of corporate governance to increase their financial performance.

### Reflective Questions

1. In the measurement of compliance with corporate governance principles, explain how to use an index and the importance of using such.
2. Using the agency theory and the stakeholder theory, discuss how you could establish the relationship between higher compliance with corporate governance principles of firms and better corporate performance.
3. “Empirical evidence always indicates a positive relationship between compliance with corporate governance principles of firms and better corporate performance.” Do you agree? Evaluate this statement.
4. Discuss and comment on the level of overall and sectoral compliance with corporate governance principles by firms in Sri Lanka as an emerging economy.
5. In this study, contrary to expectations, a negative relationship is observed between the firms’ compliance with corporate governance principles and the “market” performance of such firms. Explain.
6. Emerging economies could improve their economic growth by improving their economic performance of corporate sector. This could be achieved by increasing the compliance level of corporate governance. Do you agree? Explain with reasons.



## Appendices

### Appendix 23.1: Summary of Literature on CGI and Performance in Developed Economies

Year	Author/s	Country	Sample	Independent variable	Dependent variable	Relationship
2003	Gompers et al.	USA	1500 firms	GIM index	Tobin's Q, net profit margin, ROE, sales growth	Positive
2004	Drobetz et al.	Germany	91 public firms	CG index constructed	Tobin's market to book value, historical returns, dividend yield, sales, and asset growth	Positive
2006	Beiner et al.	Switzerland	109 firms	CG index based on Swiss Code	Tobin's market to book value	Positive
2004	Fernandez-Rodriguez et al.	Spain	57 listed firms	CG index based on Spanish Code	Daily abnormal returns	Positive
2005	Cremers and Neir	USA	1500 firms	Adopting GIM index and constructing takeover protection index	Tobin's Q, stock returns	Positive
2008	Gruszczynski	Poland	37 firms	CGI	Operating profit margin	Positive
2007	Chhaochharia and Grinstein	USA	312 firms	Self-constructed CG index	Stock returns	Negative
2008	Clacher et al.	UK	63 firms	CGI based on Combined Code	Tobin's Q, IAROA	Positive
2008	Kowalewski	Poland	298 firms	Corporate governance index	ROA and Tobin's Q	Positive
2006	Brown and Caylor	USA	1868 firms	Gov. score	Tobin's Q	Positive
2009	Bebhuk et al.	USA	IRRC firms	Enrichment index (E-index)	Tobin's stock returns	Negative
2009	Okike and Turton	UK	18 banks	CGI	ROE	Positive
2010	Bauer et al.	USA	509 firm year observations	CGQ index	Tobin's Q, net profit margin, ROE, ROA, sales growth	Positive
2012	Gordon	Canada	Small listed firms	CG index based on Toronto SE	Tobin's Q	Positive

Year	Author/s	Country	Sample	Independent variable	Dependent variable	Relationship
2012	Hassan and Ahmed	United Arab Emirates	23 national banks	CGQ index	Performance	Positive
2012	Mariani and Panaro	Italy	12 firms	CGI	EBIT	Positive
2010	Daines	California	2106 firms	CGI	Book-to-market ratio, NP margin	Mixed
2013	Ntim and Soobaroyen	South Africa	169 firms	SA CG index	Tobin's Q	Positive
2014	C. Chang et al.	Taiwan	886 firms	CGI	ROA and Tobin's Q	Positive
2015	Shahwan	Egypt	86 nonfinancial firms	Corporate governance index	Tobin's Q	Positive
2015	Rossi et al.	Italy	215 firms	CGQI	ROE, ROA, and Tobin's Q	Positive and negative
2015	Orazalin	Kazakhstan	38 commercial banks	Corporate governance index	ROA and ROE	Positive
2016	Outa and Waweru	Canada	520 firms	CG guidelines issued in 2002 by Capital Markets Authority	ROA and Tobin's Q	Positive
2018	Liu et al.	Australia	20,706 firms	Corporate governance index	Tobin's Q	Moderate and negative
2018	Ajili and Bouri	Gulf Cooperation Council (GCC) countries	44 firms	CG index	ROA and Tobin's Q	No relationship
2018	Bermi et al.	Italy	98 firms	CGI	ROI and CAR	Positive
2019	Guney et al.	USA	1203 firms	CGI	ROA	Negative

Source: Constructed based on the literature

## Appendix 23.2: Summary of Literature on CGI and Performance in Emerging Economies

Year	Author/s	Country	Sample	Independent variables	Firm performance	Relationship
2004	Bai et al.	China	1006 firms	CGI index	Market-to-book value (MTBV)	Positive
2006	Black et al.	Korea	515 firms	KCGI	Tobin's Q, market-to-book value, market-to-sales ratio, ordinary income, EBIT, EBITPA	Positive
2006	Javed and Iqbal	Pakistan	50 firms	CGI	Tobin's Q	Positive
2007	Wahab et al.	Auckland	440 firms	CGI	Stock performance	Positive
2007	Abdo and Fisher	South Africa	97 firms	Governance scorecard	MTBV and P/E ratios	Positive
2007	Nishat and Shaheen	Pakistan	226 firms	Gov. score	ROE, NP margin	Positive
2008	Garay and Gonzalez	Venezuela	46 firms	CG index	Tobin's Q	Positive
2011	Cheung et al.	Hong Kong	168 listed firms	CG index based on OECD and Hong Kong Code	MTBV	Positive
2011	Price et al.	Mexico	107 firms	CG index based on Mexico best practice	ROA, Tobin's Q, sales growth, stock market returns	No association
2011	Braga and Shastri	Brazil	15 firms	Composite index	Tobin's Q and EBIT to assets	Negative
2012	Varshney et al.	India	105 firms	CGI	EVA, ROCE, RONW, Tobin's Q	Positive
2013	Haldar and Nageswara Rao	India	50 firms	CGI	Tobin's Q	Positive
2013	Tariq and Abbas	Pakistan	119 firms	CG index based on Pakistani CG Code	ROA, ROE, ROCE	Positive

Year	Author/s	Country	Sample	Independent variables	Firm performance	Relationship
2014	Tu et al.	Vietnam	110 firms	CGI	ROA, ROE	Positive
2015	Love and Rachinsky	Russia and Ukraine	107 banks from Russia and 50 banks from Ukraine	CGI	ROA, ROE	Positive
2016	Haque and Arun	Bangladesh	140 firms	CGI	Tobin's Q	Positive
2016	Hwang and Jung	South Korea	278 firms	CGI	EBIT/sales, Tobin's Q, and market-to-book value	Positive
2017	Bhatt et al.	Malaysia	113 listed companies	CGI	ROE, ROA, and RIC	Positive
2018	Ramachandran et al.	Singapore, Malaysia	43 firms	R-index	ROE, ROA, and NP margin	Positive

Source: Constructed based on the Literature

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