THE RELATIONSHIP BETWEEN CORPORATE GOVERNANCE BEST PRACTICES AND FIRM PERFORMANCE OF SRI LANKAN LISTED COMPANIES

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ABSTRACT

This study aims to examine the relationship between corporate governance best practices and firm performance of listed companies in Sri Lanka. In today's era of globalization the corporate world requires a world – class governance system (Aggrawal 2013). Corporate Governance consists with policies, laws and regulations that describe the way the firm is managed and controlled. It is consisted both internal and external contracts between their shareholders. The purpose of this study is to investigate the relationship between corporate governance and firm performance using a sample of 100 companies listed in Colombo Stock Exchange for the period of 2013 to 2016. At the end of this research we evaluate the all listed companies in Sri Lanka using the results obtained by the sample of 100 listed companies.

Further we expect to evaluate whether the existing corporate governance best practices influence the firm performance of listed firms in Sri Lanka. The measurements of firm performance are Return on Equity (ROE) and Return on Assets (ROA) which are dependent variables. We expect to measure the independent variable, corporate governance through, Composition of Board Ownership, Board Independence, and Board Size including executive directors, independent non-executive directors, non-executive directors and CEO duality. Outcome of the study will help the interested parties of the firm's to know the level of compliance of corporate governance best practices. Also we study the factors which effect to the association between corporate governance and firm performance which of listed firms in Sri Lanka.

Methods

This study uses descriptive analysis, correlation and multiple regressions analysis as the underling the statistical test. The correlation and multiple regressions analysis have been conducted using annual reports and corporate governance reports of 100 companies listed in Colombo Stock Exchange. A descriptive analysis of the data is conducted to obtain sample characteristics.

Keywords: Board Size, Board Independence, Corporate Governance, Firm Performance.

1. INTRODUCTION

Nowadays corporate governance has become a popular discussion topic in developed countries as well as developing countries due to numerous corporate failures, scandals and frauds occurred around the world and in Sri Lanka. The reason behind those cases was the absence of corporate governance regulations in those organizations. The agency problem which focuses on the separation of ownership and control has been emphasized the necessity of sound corporate governance practices. Davis, Schoorman and Donaldson (1997) indicated more clearly that agency theory refers to the conflict between the goal of principal as owners and agent as managers.

Corporate Governance in Sri Lanka

Corporate Governance practices were commenced in Sri Lanka in 1997, with the introduction of the "Voluntary Code of Best Practices on matters relating to the financial aspects of Corporate Governance". In 2003, "Voluntary Code of Best Practices on Corporate Governance" was issued by Institute of Chartered Accountants of Sri Lanka (ICASL) .Thereafter Corporate Governance Standards were made mandatory for all listed companies in Sri Lanka for the financial year commencing on 1st April 2008.

Importance of Corporate Governance

Corporate Governance can be described as a combination of policies, laws and instructions influencing the way a firm are managed and controlled (Buallay, Hamdan & Zureigat, 2017). So, Corporate Governance is mainly considered with shareholder recognition, stakeholder interests, board responsibilities and ethical behaviour violations. Corporate Governance intends to increase the accountability of the entities to all of its stakeholders. Massive disasters can be identified and avoided if the companies are performing Corporate Governance practices effectively. Ultimately, Corporate Governance supports to upgrade the business transparency, which is vital to increase the trust of shareholder.

Problem Justification

It is certainly true that, as companies are operating in highly volatile environment, the company's performance is not only depends on the efficiency of the company itself but also on the market in which it operates. Hence it is difficult to maintain the financial stability; companies have to be concentrated on non-financial aspects as well as financial aspects to achieve long-term success.

It is also important to understand the interests and expectations of each stakeholder. Hence most of the interests and expectations are conflict each other; it is not practical to fulfil all the interests and expectations of each stakeholder. But companies have to find ways to balance the interests and expectations of stakeholders. Otherwise companies are unable to exist in this competitive market. It is considered that corporate governance is crucial to build marketplace trust and attract customers to the corporation. (Guo & Kumar, 2012)

As a result of that, the importance of Corporate Governance is heavily discussed during past few years. The introduction of Corporate Governance practices in Sri Lanka aimed to provide a platform to improve investor confidence, trust in management and promote economic development in the country. The way in which Corporate Governance organized differs from company to company, depending on the inherent characteristics of those companies.

Problem Statement

Due many corporate collapses occurred around the world, corporate governance has become popular topic that gets more concern today. Many empirical studies have been conducted to examine the relationship between the corporate governance and the firm performance around the world. But we identify that there is a lack in investigating that relationship in Sri Lankan context. So, we aim to quantify the contribution of corporate governance best practices to the performance for 100 listed companies in Sri Lanka. This research tries to find out whether there is a relationship between board independence, board size, CEO duality and board ownership and the firm performance.

Companies can attain high level of corporate governance performances if the Board of Directors (BOD) aligns their interests with other stakeholders. The BOD are central institution in the internal governance of a company and the provide a key monitoring function in dealing with agency problems in the firm (Lefort & Urzua,2008).Many studies has concentrated on BOD due to its importance when examine the relationship between Corporate Governance and firm performance.

Most of the companies adhere to the regulations relating to the Corporate Governance as it has become a mandatory code, instead of realizing its real importance to their business context. So we realize that it is necessary to explore whether there is a real relationship between Corporate Governance and firm performance and if there is a relationship, the nature of that relationship (whether there is positive or negative relationship).

Research Questions

In this study, the corporate governance is measured composition of the board, Non-executive Directors, share ownership by directors and availability of CEO-Chair duality. Similarly firm's financial performance is measured by the Return on Assets (ROA), Return on Equity (ROE), market to book value and etc. In this study the research we suppose to address the question on what are the level of corporate governance, does it effect to the firm performance and how to effect. Here we want to examine the impact on corporate governance on firm's financial side, firm's performance of the companies. Also we hope to discuss whether good corporate governance associates with the higher product market competition. To examine the questions which are mentioned above we require building up a relationship between corporate governance and firm performance. On the other hand corporate governance has effect to different level in different way. So we want to highlight the extent of corporate governance on companies. So the followings questions are going to discuss through our research;

1. Whether there is a relationship with corporate governance and financial performance?
2. If there is a correlation between corporate governance and firm performance, whether it is positive or negative and to which extent corporate governance influence on firm performance?

Research Objectives

The main objectives of this study are to find out answers for the above mentioned questions. The objectives of this study are,

- To examine the relationship with corporate governance and financial performance of listed companies in Sri Lanka
- To identify the correlation between corporate governance and firm performance and to which extent corporate governance influence on firm performance

We require clarifications that how corporate governance affects to firm financial side, firm operation and firm's market competition. For that we investigate the corporate governance practices among top few companies listed in Colombo Stock Exchange. At the first we want to find the factors affect to good corporate governance and to sort out the legal and standard situation of corporate governance practices in Sri Lankan context. In between our selected period we want to emphasize the way of adoption of the corporate governance practices in Sri Lankan companies. Through this research we want to clarify the type of relationship between corporate governance and firm performance otherwise if there is a correlation between these two variables. Further we intend to suggest the organizations to adopt good corporate governance practices towards the performance by comparing different companies' performance. On the other hand we aim to find to the impact of the ownership on the corporate governance and how different companies differentiates corporate governance. Finally our end result is to study how the relationship among corporate governance and firm performance influence the interest of the stakeholders.

2. LITERATURE REVIEW

Corporate Governance

"The system by which the company is controlled and directed" is the most common definition about the corporate governance. This chapter discusses related literatures about the corporate governance.

Finance Committee on Corporate Governance in Malaysia has defined corporate governance as 'the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective.’

From the economic perspective, corporate governance plays an important role in achieving an efficiency in which scarce funds are moved to investment project with the highest returns. It is also became a crucial determinants for institutional investments (Bushee et al., 2007).

Corporate governance is concerned with ways in which all parties interested in the well-being of the organization attempt to ensure that mangers and other insiders take measures or adopt mechanisms that safeguard the interests of the stakeholders. Corporate governance refers to a set of rules and incentives by which the management of a company is directed and controlled. Good corporate governance maximizes the profitability and long term value of the firm for the shareholders (khumani et.al, 1998).

La Porata, Lopez, and Shleifer (2000) view corporate governance as a set of mechanisms through which outside investors protect themselves against expropriation by insiders

Shleifer and Vishnvy (1997) define corporate governance as a way in which suppliers of finance to corporations assure themselves of getting a return on their investment.

Corporate Governance is crucial to build a marketplace trust and attract investors in the corporation, as well as, corporate governance encourage investors' confidence by ensure the existence of independent board of directors. Moreover, it helps provide a high level of confidence degree which is very necessary for the whole market operation, as it considers adherence to business ethics principles. (Guo & Kumara, 2012).

The corporate governance assures the shareholders that they will get return on their investment. They emphasized as the corporate governance determines the agency aspect as how shareholders motivate the managers to give their return to them. Like they pay them extra bonuses and provide different facilities just to safeguard their investment and its return (Ali, 2016).

Corporate governance has been referred to as a collective group of people united as one body with power and authority to direct, control and rule an organization (Ruin, 2001). The Australian standard (2003) defines corporate governance as the process by which organizations are directed, controlled and held to account.

The main purpose of corporate governance is to provide assurance to the shareholders that, managers are working toward achieving outcomes in the shareholders’ interests (Shleifer and Vishny, 1997).

Board Size

Board size is the total number of directors on the board of a particular company. It means how many numbers of directors are representing the board of the company. According to the Zabri, Ahmadb and Wahc (2015), the effectiveness in structuring the board is important for governing the company. Board size has been found to vary between one country and another as every country has different cultures. Lipton and Lorsch (1992) claimed that the board members on board should be between eight and nine while Leblanc and Gillies (2003) preferred eight to eleven persons on board. According to John and Senbet (1998), the determination of board size is depended on forces outside the market system. In reality, there has no optimal board size as the right size for a board should be decided by effectiveness of a board to operate as a team (Conger and Lawler, 2009).

Board Independence

Board independence can be defined as percentage of the total number of independent non-executive directors to the total number of directors. On the other hand, board independence is how much of percentage represent the independent non-executive directors out of total board. It was also defined as level of presence of independent directors or presence of non-executive directors in the board (Abdullah and Nasir, 2004). Higher number of independent directors in the board in the companies can enhance the decision credibility and objectivity (Ali, 2016).

Board Ownership

Board Ownership means, how the ownership of the company was divided among board members. Jensen and Murphy revealed that board's ownership improves the performance. Brickley et al. has concluded that the ownership of the board is an encouraging aspect for the board members. There is a positive relationship between board's ownership and firm's financial performance (Mehran). Fama and Jensen declared this aspect as "two-edged knife" which have maximum and optimal benefit and enhancement in firm's financial performance.

CEO Duality

From CEO duality, it discovers whether the positions of CEO and chairman of the board are held by the same persons. Good governance principles of governance codes highlight the fact that the roles of CEO and chairman of the company should be held by separate individuals. Fama and Jensen (1983) suggest that involvement of one personality as firm CEO Chairman would violate the separation of decision management from decision control. Daily and Dalton

(1994) concludes that there is a strong and robust positive association between CEO duality and firm bankruptcies. However, Stoeberl and sherony (1985) contend that CEO duality would provide the company with good leadership and it is an indication of firms' stability and it enhances firm communication and ultimately leading to better confidence by the investors about the company.

Firm Performance

Most of the companies try to mitigate residual risks by implementing good corporate governance in their companies (Safari et al, 2015).Mainly firm performance is measured by the financial performance. The study of Velnampy, (2013) explore the impact of corporate governance on firm performance in Sri Lankan manufacturing companies on sample of 28 companies for the period from 2007 to 2011 using the return on equity (ROE) and return on assets (ROA).Generally, it is believed that a perfect implementation of corporate governance mechanism reduces the risk for investors, enhance investment capital and improve business performance (Rezaee, 2009). ROA is defined as net income before interest expense divided by total assets. It shows the amount of earning that have been generated from invested capital assets and incorporates firm's profitability and efficiency by shareholders and all of the stakeholders. ROA measurement is a well-understood measure of the organizations and it represented the actual firm performance. ROE is defined as the income before interest expense for the fiscal period divided by total shareholders' equity for that same period. ROE has been proven to be a trusted performance measure for corporate stakeholders and it is suitable both in short-term and long-term for most investors (Zabria, Ahmadb, Wahc, 2016).

The firm performance is dividing into three subsets which are market performance, financial performance and operational performance. The impact of corporate governance on firm performance has been discussed widely around the world, different performance measures were used to explore the effect of corporate governance on firm performance such as operational based measures, market based measures and financial based measures. The results found that corporate governance is significantly correlated with firm performance (Buallay, Hamdan, and Zureigat, 2017).The literature testing the relationship between different corporate governance mechanisms and firm performance is extensive. The most used performance measures are: Tobin's Q, return on equity, return on asset and economic value added.

The study conducted by Sayla Sowat Siddiqui, (2015) found that, Studies addressing the association between governance and financial performance use accounting value (ROA, ROE and return on sales) or market value (Tobin’s Q and MBV) as performance measurement. And their results entail that corporate governance is not significantly related to accounting value measurement of firm performance measured by ROA and ROE.

Dr. A. A. Azeez (2015) conducted a study on relationship between corporate governance and firm performance in Sri Lanka that involved 100 listed companies and they have used EPS, ROA, and ROE as measures of firm performance. The results revealed that just mere presence of non-executive directors on corporate boards within the company would not enhance firm performance.

Padmanabha Ramachandra Bhatt and R. Rathish Bhatt, (2017) have given detailed surveys on how corporate governance framework affected firm performance in Malaysian companies. They have taken the mean ROE, ROA and ROIC for the accounting measures of performance in their study. They have found a positive and significant relationship between corporate governance implementation and firm performance. Their findings imply that corporate governance rules and practices, indeed, improve the performance of firms.

The research on “whether better CG may or may not be related to higher organizational performance” noted that both accounting and market measures are considered as measures of firm performance. In this study, they have used two measures of firm performance; (I) Return on Equity (ROE) and (II) Market to Book Value Ratio (MTBVR)(Roy, 2016).

Relationship and how effect

When we talk about relationships, that may be positive, negative or no relationship. Also if there is a relationship, that may be strong or weak. Researchers indicated that there is a relationship between corporate governance and firm performance. Some researchers found that, it is a positive relationship between corporate governance (board size) and firm financial performance (Shukeri et al., 2012; Adam and Mehran, 2003; Mak and Kusnadi, 2005; Kiel and Nicholson, 2003). Some researchers showed that corporate governance measurements are positively relates with performance of the firm. Similarly, one research specified that board size is positively related to firm’s earning per share (EPS) among listed companies in China (Chen et al. 2006). Another research found that board independence can provide benefits to company’s overall performance (Ramdani and Witteloostuijn, 2009; Zubaidah et al., 2009; Rhodes et al., 2010). But Lakhal (2005) found that board size and firm performance is positively relates but it is not a strong relationship.

According to Abdullah (2004), Independence of the ownership is also effect to the firm effectiveness by a way that independent directors can bring independence into the board and add to diversity of skills and expertise of the directors. Independent directors are able to mitigate agency problems and control managerial self-interest (Rhodes et al., 2000).

Nowadays corporate governance is more important. Because of that some countries are mandatory required to adopt corporate governance but some countries do not mandatory required that. In Saudi, all Saudi listed companies are required to adopt the corporate governance regulations due to the importance of corporate governance for effective financial, operational and markets performance. Therefore, a perfect implementation of corporate governance mechanism reduces the risk for investors, enhance investment capital and improve business performance (Rezaee, 2009).

While Khamis, et al., (2015) found that there is a significant relationship between performance and ownership measured by ROA in Bahraini listed companies, the study sample was 42 companies for 5 years from 2007-2011, the analysis shows that institutional ownership has a negative relationship on company performance if measured by ROA. However, it was found that managerial ownership has a positive effect on performance.

3. RESEARCH METHODOLOGY

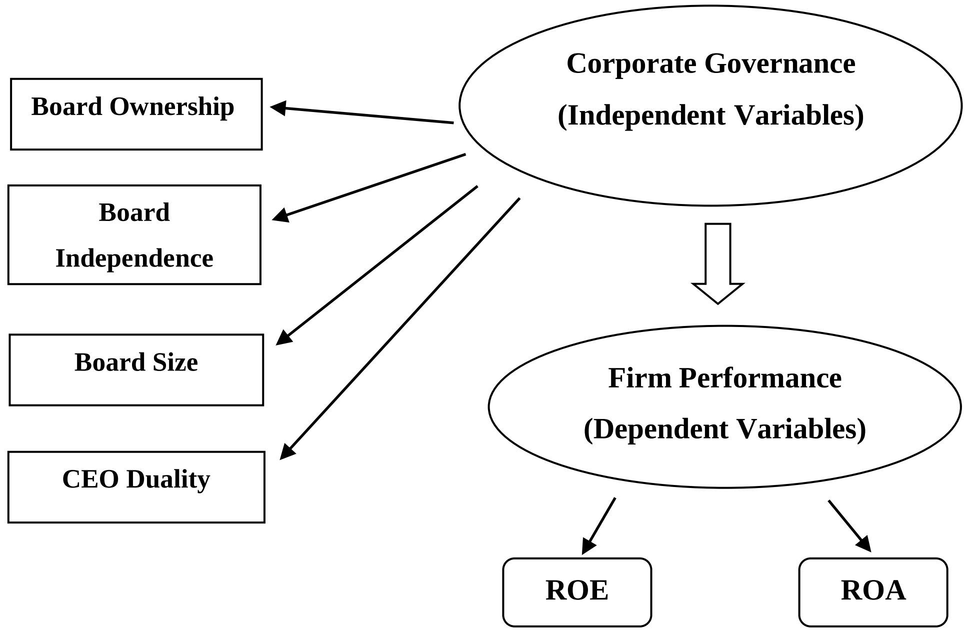
As previously discussed in the literature review section, many studies have used cross sectional and longitudinal design in identifying association between corporate governance and financial performance. Most of the studies which have used longitudinal design have documented the post and prior effects of implementing corporate governance code on the magnitude of the earnings management practices (Kang et al. 2013). Though, in our study we used the cross-sectional approach to identify the relationship between corporate governance and financial performance from a sample of listed companies in Colombo Stock Exchange (CSE).

Data Sample

The Data which were used for this study was collected from the Colombo Stock Exchange (CSE) data base. Selected companies have been arranged according to their market value from highest value to lowest value for top 100 listed companies including all the sectors except Banking and Finance sector in CSE. Since there are more than 298 listed companies on stock market exchange at the end of 31 March 2018. 100 largest companies were selected based on the highest market value which represents the majority from the whole population of companies in Sri Lanka on CSE to be able progress our study. Firms used in the sample were selected according to data is available in the period of 2013 to 2017. Firms have not been turned off or merged with other firms during the research period. Seven companies of those 100 listed companies were excluded due to the data limitations. The sample contains divers listed companies from nineteen sectors different industries

Information of board of directors and ownership concentration data are second hand data and obtained from annual report and financial statement.

Conceptual Diagram



Measurement of Variables and Descriptive Statistics

<u>Independent variables</u>

Independent Variables of Corporate governance variables are shown in other studies, which associate with financial performance in firms. Such variables include CEO duality (Gelderen 2013; Roodposhti & Chamshmi 2011; Iqbal et al. 2015), Board independence (Gelderen 2013; Roodposhti & Chamshmi 2011; Kim & Yoon 2008; Kang et al. 2013), Board ownership (Davidson et al. 2001; Uwuigbeet al.2014), Board meetings (Abbadi et al. 2016) and Board size (Amer and Abdelkarim 2010). So, we selected the above-mentioned variables as independent variables for the corporate governance aspect.

CEO Duality

CEO duality is where the chairman or chairperson of the board and the CEO of the company being held by same person. We identified this variable by referring to the section of Governance in the particular annual reports.

H1: There is a negative relationship between CEO duality and firm performance

Board Independence

In the Code of best practice on corporate governance in Sri Lanka, it is specifically recommended that the number of non-executive directors in the board should be at least two or one third of total number of directors whichever is higher. This variable was measured by considering the number of Non-executive directors as a proportion of total number of directors.

H2: There is a positive relationship between board independence and firm performance.

Board Ownership

The ownership of the company was divided among board members. The percentage of share capital owned by board of directors to total capital is means by the board ownership.

H3: There is a positive relationship between board ownership and firm performance.

Board Size

Board size was measured by the number of Directors of the company. A larger size of Board assumes a superior supervision of the management team and a higher quality of corporate decisions (Pearce and Zahra, 1992)

H4: There is a positive relationship between board size and firm performance.

Dependent variables

This study aims at investigating the effects of corporate governance on firm's performance, so the firm performance is measured using two proxies, Return on Equity (ROE) and Return on Assets (ROA).

Return on Equity (ROE)

ROE is defined as the income before interest expense for the fiscal period divided by total shareholders' equity for that same period.

$$\text{Return on Equity (ROE)} = \frac{\text{Profit after tax}}{\text{Shareholders' Equity}}$$

Return on Assets (ROA)

ROA is defined as net income before interest expense divided by total assets. It shows the amount of earning that have been generated from invested capital assets and incorporates firm's profitability and efficiency by shareholders and all of the stakeholders.

$$\text{Return on Assets (ROA)} = \frac{\text{Profit after tax}}{\text{Total Assets}}$$

Data Analysis Strategies

Statistical Package for Social Sciences (SPSS) was used to assess and analyse the collected data to examine the relationship between corporate governance practices and firm performance. There are two methods of analysis used in this study, which are descriptive and correlation analysis. These methods were used as the underlying statistical tests to describe the original characteristics of a data set and are the key to summarizing variables, and also examining the relationship between two different variables.

4. FINDINGS AND DATA ANALYSIS

Descriptive Statistics

Table 1 presents descriptive statistics of corporate governance characteristics and firm financial performance measures. The average number of persons on the board of directors is 9, with about 54% of them being non-executive managers or independent members. In the overall samples for this study, have 22.83% of the sample of firms has CEO duality and

77.17% has no CEO duality, which means most of the firms appointed individuals to assume the Chairman and CEO roles separately. The average share ownership of board of directors in the sample represents 26.89% from the total shareholding of the companies.

This descriptive statistics suggest that Sri Lankan listed companies is moving towards practicing good governance mechanisms that firms has shown an increased interest complying with combined code on Corporate Governance 2008 which has been issued by ICASL and SEC by maintaining two separate persons for the roles of Chairman and CEO and also including higher proportion of non-executive directors in corporate boards. This kind of movement by the Sri Lankan companies towards adopting good governance mechanisms could be seen as a positive trend despite the slow paced Corporate Governance reforms that had taken place in Sri Lanka.

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	Mean	Median	Minimum	Maximum	SD
Board Of Directors	9.025	9	5	20	2.31
CEO Chair Duality	0.2283	0	0	1	4.20
Non- Executive Directors	0.5403	0.5000	0	1	0.2536
Share Ownership of Directors	0.2689	0.2905	0	0.80	0.2504
ROE	0.3706	0.2000	-0.14	8.06	0.8578
ROA	0.0967	0.0800	-0.15	0.65	0.0959

Table: 1 – Descriptive Statistics

Correlations

Table 2 presents Pearson's correlation for all the variables in the study. It examined the association between the corporate governance variables and firm performance variables. There is a negative correlation between the separation of the roles of CEO and Chairman and firm performance as measured by ROA and ROE. Nonexecutive director proportion is positively correlated with ROA and negatively correlated with ROE. Board size is positively correlated with ROE. However it shows a negative correlation with regard to ROA. Share ownership of directors is positive with both ROE and ROA.

ROA is net profit after tax divided by total assets. ROE is net profit after tax divided by total equity. CEO Chair Duality is an indicator of whether or not a firm's CEO is also the chair of the board of directors. Nonexecutive Directors is the proportion of non-executive directors on the board; Board Size is the number of directors on the board and Share ownership of directors indicates the number of shares hold by the directors from total shareholding.

Some researchers indicated that there is positive relationship between board size and firm performance (Shukeri et al., 2012; Adam and Mehran, 2003; Mak and Kusnadi, 2005; Kiel and Nicholson, 2003).

Likewise some researchers found that board independence can provide benefits to companies (Ramdani and Witteloostuijn, 2009; Zubaidah et al., 2009; Rhodes et al., 2010).

According to Abdullah (2004), independent directors can bring independence into the board and add to diversity of skills and expertise of the directors. Independent directors are able to alleviate agency problems and curb managerial self-interest (Rhodes et al., 2000).

While Khamis, et al., (2015) found that there is a significant relationship between performance and ownership measured by ROA in Bahraini listed companies, the study sample was 42 companies for 5 years from 2007-2011, the analysis shows that institutional ownership has a negative relationship on company performance if measured by ROA. However, it was found that managerial ownership has a positive effect on performance.

In Saudi, all Saudi listed companies are required to adopt the corporate governance regulations due to the importance of corporate governance for effective financial, operational and markets performance. Therefore, a perfect implementation of corporate governance mechanism reduces the risk for investors, enhance investment capital and improve business performance (Rezaee, 2009).

		Board of Directors	CEO Chair Duality	Share Ownership of Directors	Non-Executive Directors	ROE	ROA
Board of Directors	**- Pearson Correlation**	1					
	Sig (2 Tailed)						
	N	368					
CEO Chair Duality	**- Pearson Correlation**	.056	1				
	Sig (2 Tailed)	281					
	N	368	368				
Share Ownership	**- Pearson Correlation**	348	-.031	1			
	Sig (2 Tailed)	000	548				
	N	368	368	368			
Non-Executive Directors	**- Pearson Correlation**	-135	-.177	-.550	1		
	Sig (2 Tailed)	.009	001	000			
	N	368	368	368	368		
ROE	**- Pearson Correlation**	-.077	-.033	.010	115	1	
	Sig (2 Tailed)	143	530	853	028		
	N	365	365	365	365	365	
ROA	**- Pearson Correlation**	.077	0.33	010	010	1000	1
	Sig (2 Tailed)	140	534	855	855	000	
	N	367	367	367	367	365	367

Table: 2 - Pearsons' Correlation

Regression Results

Table 3 shows ordinary least squares regression results for each of EPS, ROA and ROE on the independent variables. The results derived from the regression analysis reveals that the separation of the two posts of CEO and chairman has a significant positive relationship with the firm performance as measured by ROA,

ROE and ROA based on the results, it proves that separate leadership structures would lead to better performance of the listed companies in Sri Lanka. The results of the research supports the hypothesis, which states that separation of the roles of CEO and chairman, would lead to higher performance and the hypothesis is accepted at 5% significance level. In the Sri Lankan context, the importance of separating the roles of CEO and chairman has been stressed by the amended corporate governance code 2008 issued by SEC and ICASL. However, though it is not compulsory we could observe that companies in the sample followed an increasing trend of separating these two roles and therefore it could be argued that separation of these two roles has positively influenced towards the corporate performance of the listed companies in Sri Lanka.

However, though it is not compulsory we could observe that companies in the sample followed an increasing trend of separating these two roles and therefore it could be argued that separation of these two roles has positively influenced towards the corporate performance of the listed companies in Sri Lanka.

Non-executive directors in the board are considered as an important governance mechanism which promotes better governance. Regression results indicate that the relationship that exists between number of non-executive directors and firm performance is negative and insignificant at 5% significance level. Therefore the hypothesis that higher proportion of non-executive directors in the board would lead to higher performance is rejected.

Though many scholars argued that non-executive directors improve performance, it is questionable this really take place in the Sri Lankan context where the current research results also holds the view point that proportion non-executive directors has no significant positive association with firm performance. This is because given the relationship that exist within Sri Lanka a question could be raised as whether the non-executive directors are really in a position to make proper informed decisions and also whether the independent non-executive directors truly fulfils the non-executive director characteristics which the best practice code recommends. Researchers have attempted to study the most absolute number of directors that should present in the board to obtain better performance

Finally, the test results indicate that the leverage ratio of the firm does not have a statistically significant effect on firm performance

	Observations	ROE			ROA		
		R Square	F	Sig.	R Square	F	Sig.
Non-Executive Directors	365	0.084	33.665	0.000	0.013	4.895	0.028
CEO Chair Duality	365	0.001	0.273	0.602	0.001	0.387	0.534
Share Ownership By Directors	365	0.054	21.005	0.000	0.000	0.033	0.855
Board Size	365	0.000	0.167	0.683	0.006	2.187	0.140

Table: 3 – Regression Result

5. CONCLUSION, LIMITATIONS AND SUGGESTIONS FOR FURTHER RESEARCH

This study examined association between financial performance and corporate governance best practices based on the 100 companies listed in the Colombo Stock Exchange. We investigated whether CEO duality, board size and board independence and board ownership would reduce the rate of return on equity and return on assets.

Our regression analysis suggest that Sri Lankan listed companies is moving towards practicing good governance mechanisms that firms has shown an increased interest complying with combined code on Corporate Governance by maintaining two separate persons for the roles of Chairman and CEO and also including greater proportion of non-executive directors in board of directors. That depicts firms which have two separate positions for Chief Executive Officer and Chairman are more effective.

This shows that there is a negative correlation between the separation of the roles of CEO and Chairman and firm performance as measured by ROA and ROE which result the firm financial performance. We further found that non-executive director proportion is positively correlated with ROA and negatively correlated with ROE. Board size is positively correlated with ROE. However, it shows a negative correlation with regard to ROA. Share ownership of directors is positive with both ROE and ROA.

Regression result proves that separate leadership structures would lead to better performance in firm’s financials. Also that of supports the hypothesis, which states that CEO chair duality, would lead to higher financial performance and the hypothesis is accepted at 5% significance level.

Regression results show that the relationship between number of non-executive directors and firm performance is negative and insignificant at 5% significance level.

This paper reviews board characteristic of listed firms in Colombo stock exchange and their relationship with financial performance. Therefore, this study contributes to the prevailing literature related to corporate governance and financial performance.

However, this study is subject to several limitations. First, we only consider board characteristics as the corporate governance variables. Second, only 100 companies were used to collect data which may be unable to generalize for other companies. Third, our results show an association between financial performance and corporate governance instead of explaining causation between corporate governance characteristics and financial performance.

Therefore, future research may need to investigate how other aspects of corporate governance impact on financial performance.

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