Board Structure and Financial Performance of Listed Finance Companies in Sri Lanka

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Abstract

This study investigated the relationship between board structure and financial performance of listed finance companies in Sri Lanka. Data were gathered from the financial statements of randomly selected 20 finance companies which are listed on CSE under Bank, Finance and Insurance Sector for the period of 2011-2015. Financial performance was measured by return on assets (ROA). Board size, female board members, CEO duality, and non-executive directors were considered as the parameters of board structure. Furthermore market capitalization was taken as the control variable. Pooled OLS was performed using STATA for the analysis of data. Results of the study revealed that board size and non-executive directors had significant relationship with ROA. Besides, female board and CEO duality were not significantly related to ROA. This study may helpful for the practitioners and policy makers to maximize the profit. Moreover, analyzing the relationship between board structure and financial performance of firms offering non-financial services can also be a worthwhile research.

Keywords: board structure, financial performance, listed finance companies

1. Introduction

Board structure is a crucial aspect in the area of corporate governance, since it is treated as a central point of internal governance of the company. Overall behavior of the company can be changed with the changes of a board structure, because every strategic level decision taken by board of a company can impact on entire operations of a firm (Arosa et al., 2010). The handbook of nonprofit governance says, when aligned with the strategic priorities of a firm, an efficient structure allows board and staff to apply their skills in concert to fulfill the mission. Therefore, it is discussed in the initial point of “code of best practice on corporate governance” published in Sri Lanka. It says that every public company should be headed by an effective board, which should direct, lead and control the company. Effectiveness of the board performance is influenced by various factors such as board composition, quality, size, diversity of the board, CEO duality, ownership, information asymmetries and culture of the board (Brennan, 2006).

Since board of directors is acting as representatives for shareholders of the company, they have primary responsibility to monitor the management of such company. Further, the board advises the management and has decision making power. Therefore, shareholders should have a serious interest in ensuring that the board is staffed with well-educated and experienced directors as board of directors is vested with the responsibility of ensuring that the shareholders’ money is not wasted (Akpan and Amran, 2014).

In order to reduce sudden larger decline of the share price of the companies, the importance of board for the success of a firm is paid huge attention recently. Therefore, corporate governance practice has been adopted in larger number of countries including Sri Lanka. According to the World Bank (2006), efficient board structure enhances a firm’s performance, reduces the costs of capital, adds values to firm, and improves the control of risk, which ultimately lead to sustainable growth for companies and contribute to healthy economic development for the country.

Financial institutions functioning in Sri Lanka are facing many challenges and problems due to huge number of competitors. In this way board structure and their activities are very helpful to lead every financial organization in successive way among their competitors. Financial services organizations in Sri Lanka had almost lost their confidence of the general public due to the collapse of golden key company during the global financial crisis in 2008. Many debates pertaining to this issue came up and some view the problem as a governance issue. After these issues many researches have been conducted to find out the relationship of corporate board structure with financial performance. However, according to the various characteristics, board structure has contradict relationship with financial performance of the company. Thereby, research intension to find out the relationship between board structure and financial performance of finance companies listed in Sri Lanka has been generated.

2. Literature Review

2.1 Theoretical Perspectives

This study is carried out under for theories such as agency theory, stewardship theory, resource dependency theory and stakeholder theory. These are commonly used to investigate this relationship between board structure and financial performance.

a) Agency theory

Fundamental aspect of agency theory is that shareholders (principle) are not involving in the daily business operations and management of the firm. Therefore, they hire mangers (agent) to manage the firm on behalf of them. However, purpose of managers is differing from the shareholders (Habbash, 2010). The managers are working to secure only their personal wealth, thereby shareholders interest is paid with less attention. There will be no agency problem, when interest of principal and agent coincide (Eisnhardt, 1989). According to the Coleman, 2007, agency problem can be managed by incorporating large percentage of independent directors for monitoring management effectively.

b) Resource dependency theory

The theory says about basic responsibility of the board. The board of directors should be not only a member of a board but also a capital of a firm. Therefore, they should bring resources to the firm like information, skills, knowledge, access to important element and authority. Thereby they can maximize value of the firm (Hillman et al., 2000). Therefore, the firm should encourage attracting external directors with knowledge in various area. According to Chemweno, 2016, board with strong external links is a co-optation mechanism for firms to access external resources.

c) Stakeholder theory

This theory reveals that there are various stakeholder of the organization in the external environment with different interest. Some of them help the organization and rest of them hurt the organization. Therefore, governing board of the firm should compromise with them in the interest of the organization (Hung, 1998).

d) Stewardship theory

Stewardship theory assumes that managers of the firm essentially want to do a good job, unlike agency theory which takes managers as opportunistic shirker (Donaldson, 1990). Theory considers manager as steward. Davis et al., (1997) argued that agents are trust worthy custodians for resources in the organization, because they are keen to secure their position as expert decision makers. Thereby they wish to run the firms in a way that maximize financial performance as well as value of the firm.

2.2 Empirical Review

A number of researches have been conducted in various countries including Sri Lanka, but result of each studies do not reveals consensus findings.

Board size

The optimum size of the board is not documented in any universal standards. According to the Corporate Library's study, the average board size is 9.2 members, and most boards range from 3 to 31 members. Previous researches revealed different types of relationship between board size and financial performance. Zabri et al., (2016) have found that board size has significant weak negative relationship with ROA in their research conducted in Malaysia using 100 public listed companies. But there are some other researchers found that there is a positive relationship between board size and firm performance (kalsie and shrivatav, 2016, Shukeri et al., 2012 Mak and Kusnadi, 2005). Studies have been done in Sri Lanka found that board size and proportion of non- executive directors in the board shows a marginal negative relationship with firm value (Udaya kumara, 2012, Azzez, 2015).

Non-Executive directors

A non-executive director is one member of a company board, but he or she doesn't involve in the works of management team. According to the code of best practice on corporate governance 2013, the board should include Non-Executive Directors of sufficient caliber and number for their views to carry significant weight in the board's decisions. The board should include at least two Non-Executive Directors or such number of Non-Executive Directors equivalent to one third of total number of Directors, whichever is higher. Fuzi el at, (2016) carried out a study to examine board independence and firm performance in few countries. They found that there is a mixed association between proportions of independent directors and firm performance. Further they said that the companies comprised the highest number of independent directors, it would not assure to enhance firm performance. Abdullah (2004) revealed in his research that there was no association between the board's independence and the CEO's duality with performance. However, Rostami el at., (2016) found that there is a significant positive relationship between board independence and stock return in their study.

Female board

Basically there is a perception among the people that if there is lager number of female representatives, there will be lower performance (Adams and Ferrera 2009). Therefore, researches including the variable of female representatives have been carried out. According to the Carter et al., (2003) a higher proportion of female directors at the board associates with better performance. Erhard et al., (2003) and Campbell and Minquezvera, (2008) have found that there is a positive relationship between proportion of female directors and firm performance. However, there are some other researchers have found that there is a negative effect of higher proportion of female directors in the board(Adams and Ferreira,2009 and Ahren and Dittmar, 2012).

CEO duality

It means Chief Executive Officer plays two roles with the position of chairman. One part of researchers support that separation of CEO and chairman role maximize firm performance (Duru el at.,2016, Doganel at., 2013 and Gillan, 2006). But other part of researchers support that when these two positions are performed by only one person, it will lead to monitor and implement control throughout the firm (Adams, Almeida and Ferreira, 2005). Rostami el at., (2016) have carried out a study to find out the effect of corporate governance components on return on assets and stock return of companies listed in Tehran stock exchange. Through which they found that CEO duality positively associates with stock return. Kengatharan and Suganya (2017) found that there is a significant negative relationship between CEO duality and performance of listed manufacturing companies in Sri Lanka.

Most of the researches concerning board structure and firm performance have been carried out before 2013. In Sri Lanka, code of best practice on corporate governance have been revised in 2013. One of the key amendments in such version is that reporting internal control, risk management and related responsibilities of the audit committees and boards of directors. Therefore, researchers suspect that there may be a difference in finding of this study due to the inclusion of more responsibilities of board of directors in Sri Lankan listed companies. Further, most researchers have considered only listed manufacturing companies to find out the relationship between board structure and firm performance. Managing behavior of board of directors in financial institutions may be different from the directors in non-financial institutions due to the risk managing behavior. Therefore, researchers have paid more attention on board of directors in financial institutions.

Based on the theoretical and empirical review, a research model was formulated to investigate the relationship between board structure and financial performance of listed finance companies in Sri Lanka. Conceptual frame work is presented below demonstrating the relationship between variables.

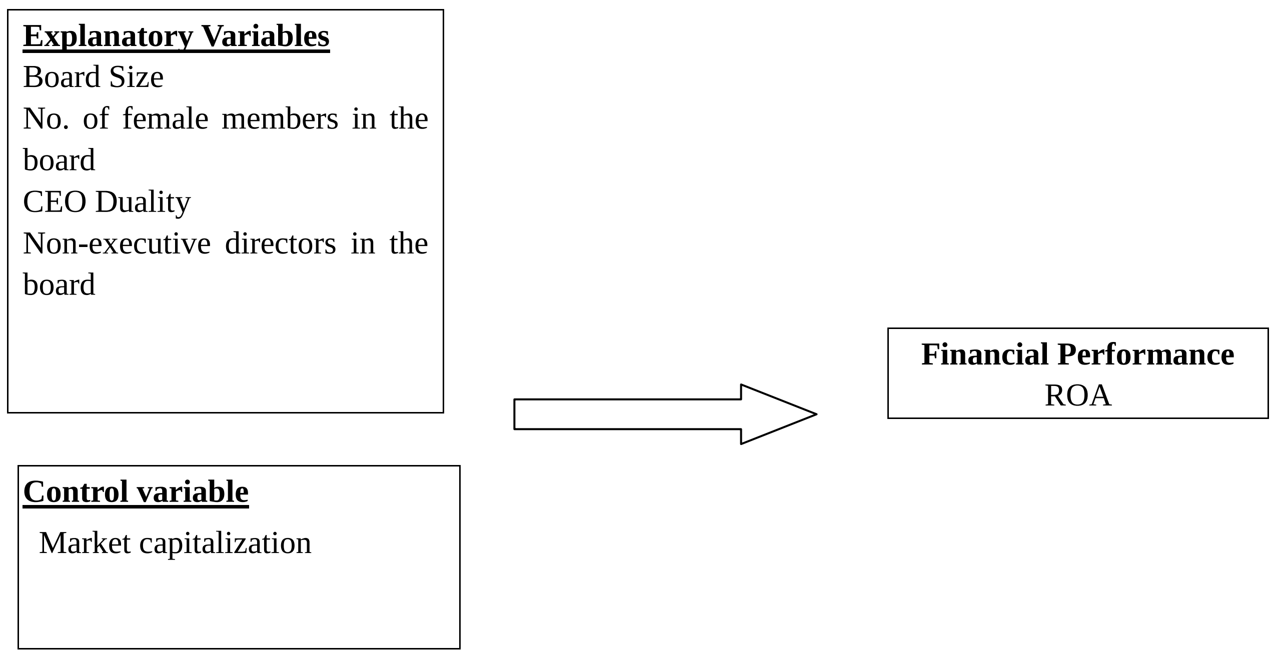

Figure 1. Conceptual framework

Board structure has been measured by board size (total number of board of directors), female board members (number of female members in the board), CEO duality (Dual role of the CEO), and non-executive directors (number of non-executive directors in the board). Market capitalization has been considered as control variable. Financial performance has been measured by return on assets. After developing the conceptual frame work, following hypothesis has been formulated to investigate the relationship between board structure and financial performance:

H_1: There is a significant relationship between board structure and firm's financial performance of listed finance companies in Sri Lanka

3. Research Design

3.1 Sample and Data Collection

This study is carried out to examine the relationship between board structure and financial performance of finance companies listed in Sri Lanka. For the purpose of analysis, data was collected from randomly selected 20 finance companies from bank, finance and insurance sector of Colombo Stock Exchange (CSE) in Sri Lanka for the period of five years from 2011 -2015. Secondary data was used from the annual report of particular companies published on the CSE website.

3.2 Variables

Explanatory variables in this study are board size (BS), female board members (FBM), CEO duality (CEO_D) and non-executive directors (NED). Return on assets (ROA) has been considered as criterion variables and control variable was market capitalization (MCap). Measurement of the variables have been listed below:

Variables	**Indicators**	**Measurement**
Board Size	Number of board members in the board	Number of inside and outside directors on board
Female board	Number of female members in the board	Number of female members/ total board members
CEO Duality	CEO-Chairman dual role	Coded “1” if chairman also holds the position of CEO and “0” otherwise
Non-executive directors	Number of non-executive members on the board	Number of non-executive directors/ total board of directors
Market capitalization	Total amount of market capitalization	Log of market capitalization
ROA	Ratio of return to total asset	Earnings before Interest and Tax / Total Assets

The empirical model is given as following:

$$ROA = \alpha + \beta_1 BS + \beta_2 FBM + \beta_3 CEO\_D + \beta_4 NED + \beta_4 MC + \varepsilon \qquad (1)$$

4. Data Analysis

Table 1. Descriptive statistics of the variables

Variables	Obs	Mean	Std.Dev	Minimum	Maximum
Board Size (BS)	100	9.62	2.32	5	16
Female Board Members (FBM)	100	1.34	1.33	0	5
CEO_duality (CEO_D)	100	0.2	0.40	0	1
Non Executive Directors(NED)	100	3.49	2.12	0	9
Market Capitalization (M_Cap)	100	22.75	1.48	18.84	25.65
Return on Assets (ROA)	100	0.03	0.02	-0.08	.11

Source: survey data

As result of the descriptive analysis presented in the Table 1, minimum number of board members were 5 and maximum was 16 members on the board. Thus as average board size was 10 (9.62) members on the board with the standard deviation of 2.32. Minimum number of female members on the board were 0 and the maximum was 5. There was maximum 1 member who plays the CEO dual role on the board. On average of 0.2 was the CEO duality with the standard deviation of 0.403. Average non executive directors on the board is 3.49 with the range of minimum was 0 and the maximum was 9. The market capitalization ranged between 18.84 and 25.64 and an average was 22.75 with the standard deviation of 1.48. Average ROA was reported that 3% for the listed finance companies which was ranged from -8% to 11%.

Table 2. Correlation analysis

	BS	FBM	CEO_D	NED	M_Cap	ROA
BS	1.0000					
FBM	0.1594	1.0000				
	0.1131					
CEO_D	-0.1991**	0.0602	1.0000			
	0.0470	0.5517				
NED	0.5636***	-0.0809	-0.2702**	1.0000		
	0.0000	0.4238	0.0066			
M_Cap	0.2965**	0.1786	-0.0897	-0.0019	1.0000	
	0.0027	0.0754	0.3746	0.9848		
ROA	0.0796	0.0308	0.0889	-0.1966**	0.1819*	1.0000
	0.4311	0.7613	0.3790	0.0499	0.0701	

Source: survey data

Results of the correlation analysis is presented in the Table 2. As per the results presented in the Table 2, board size(r = 0.0796, p> 0.05), female board members (r= 0.0308, p > 0.05) and CEO duality (r= 0.0889, p > 0.05) were not significantly associated with the ROA. Non-executive directors (r = -0.1966), p < 0.05) were significantly negatively associated with ROA. Further, market capitalization (r= 0.1819, p < 0.1) was positively associated to the ROA with the 10% of significant level. Therefore, it can be concluded that there was significant negative association between non-executive directors and ROA. Market capitalization was significantly positively associated with the ROA. Board size, female board members and CEO duality were not significantly associated with ROA.

Regression Analysis - Pooled Ordinary Least Square

Regression analysis was used to investigate the strength of relationship between corporate governance practices and firm performance of the listed manufacturing companies in Sri Lanka.

Table 3. Regression analysis for the model

$$ROA = \alpha + \beta_1 BS + \beta_2 FBM + \beta_3 CEO\_D + \beta_4 NED + \beta_4 MCap + \varepsilon \quad (1)$$

Source	SS	Df	MS
Model	.0065	5	.0013
Residual	.0525	94	.0005
Total	.0590	99	.0013

Number of obs	=	100
F (5,94)	=	2.32
Prob > F	=	0.0492
R- squared	=	0.1099
Adj R-squared	=	0.0625
Root MSE	=	0.02363

ROA	Coef.	Std.Err	t	P > t	[95% Conf. Interval]	
BS	.0026	.0014	1.92	0.058	-.0001	.0053
FBM	-.0011	.0019	-0.60	0.549	-.0048	.0026
CEO_D	.0039	.0062	0.65	0.520	-.0083	.0163
NED	-.0037	.0014	-2.58	0.011	-.0066	-.0008
M_Cap	.0020	.0017	1.19	0.239	-.0014	.0055
-cons	-.0284	.0376	-0.76	0.451	-.1031	.0462

Source: survey data

According to the pooled OLS results presented in the Table 3, value of coefficient of determination of dimensions of board structure of listed finance companies in the study which ($\boldsymbol{R^2}$) was 0.1099, whilst this result implies that 10.99 % of total variance in ROA can be explained by all dimensions of board structure. As the model reveals the remaining 89.01 % of variability was not explained in this model. An analysis indicates that $F = 2.32$, p < 0.05 that model was significant.

As result presented in table 3, among the four variables of board structure, board size and non-executive directors have been identified as a significant predictors with coefficient weights of .0026 (P < 0.1) and -.0037 (P <0.05) respectively resulted on ROA. It can be concluded that board size significantly positively related with ROA and number of non-executive directors significantly negatively related with ROA. Rest of the other variables, female board members (Coef =-.0011, P> 0.05), CEO_duality board size (Coef =.0039, P> 0.05) and market capitalization (Coef =.0020, P> 0.05) were not significantly related to ROA.

Research question of this study is to what extent board structure impacts on financial performance of finance companies in Sri Lanka. Finally study has answered the research question through the result of the Pooled OLS, stating that 10.99% variability on ROA has been explained by independent variables. Among the four variables considered in the study under board structure, board size had significant (10% significance level) positive relationship with firm performance. However, non-executive directors had significant (5% of significance level) negative relationship with firm performance of listed finance companies in Sri Lanka. Hypothesis ($\mathbf{H_{1}}$) of this study stated that there is a significant relationship between board structure and firm performances. According to the results of the study hypothesis was supported that board size and non-executive directors had significant relationship with ROA of selected listed finance companies on CSE while female board and CEO duality did not have any significant relationship with ROA.

5. Discussion and Conclusion

This study investigated the relationship between board structure and financial performance of listed finance companies in Sri Lanka. Data were gathered from the financial statements of 20 finance companies which are listed on CSE for the period of 2011-2015.Based on the empirical result of this study, it can be concluded that board size and non-executive directors had significant relationship with ROA. Furthermore, female board and CEO duality did not significantly related to ROA. Finding of this study may helpful for the practitioners and policy makers to maximize the profit. This study only considered listed finance companies in Sri Lanka, it can be considered as a limitation for generalizing the finding of this study. Therefore, better results can be obtained by considering all companies for an extended time period. Furthermore, analyzing the relationship between board structure and financial performance of firms offering non-financial services can also be a worthwhile research. In addition, cross country analysis among the emerging countries and the developed countries can also be a substantial dimension for future research.

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