IMPACT OF SELECTED BOARD CHARACTERISTICS ON FIRM PERFORMANCES OF LISTED MANUFACTURING FIRMS IN SRI LANKA

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ABSTRACT

This study designed to investigate the association between selected board characteristics and firm performances of organisations registered under the manufacturing sector of the Colombo Stock Exchange. Accordingly, 28 companies have been used as sample over four years (2014 -2017) with the main objectives to measure the level of corporate governance and board characteristics of selected companies and to examine their association. ROA and ROE used as the dependent variables of the study and board size, board independence, board meetings, board diversity, CEO duality and existence of nomination committee as board characteristics used as independent variables while controlling for three variables (i.e., firm size, age and leverage). Results obtained via correlation analysis, OLS regression and panel regression showcase that only board diversity and existence of nomination committee possess the significant impact on firm performances. Leverage is the only control variable which become negatively significant in explaining the variation of firm performances. The study suggests vital managerial implications to policy makers in reforming and strengthening corporate governance guidelines to achieve higher firm performance.

Key Words: Firms' performance, corporate governance, board characteristics, manufacturing sector

1. Introduction

The manufacturing sector is one of the most important sectors in the Colombo Stock Exchange, since its contribution to the Sri Lankan economy is vital. There are 38 manufacturing companies registered in the CSE as at 31st March 2017 which consists of local companies as well as multinational companies. In a situation where the production is essential for economic development in Sri Lanka, investigation on financial performances of manufacturing sector organisations is worthwhile.

Moreover, it may be interesting to investigate how corporate governance practices affect the performance of manufacturing organisations.

In the face of scandals and financial crisis, corporate governance places a greater emphasis on many countries. Due its significant importance, it has become a mandatory requirement in many economies in their corporate reporting which ensure protection of investors (Beiner, Drobetz, Schmid & Zimmerman 2004). Corporate governance ensures a trustworthy environment while keeping up a long-term relationship between the organisation and all the stakeholders (Aras & Crowther, 2008). With the increasing frauds and misbehaviours of the management, investors demand for corporate governance become severe and then it turned out to be one of the main factors on which investors base their decisions (Aras & Crowther, 2008). Execution of corporate governance is a main responsibility of "agents" appointed by principals (i.e, shareholders or the owners of corporations). Board of directors are the main operators of corporate governance (Jensen & Meckling, 1976). It is believed that board of directors could have direct influence on corporate reporting of the organisation as well as the operational success (Jensen & Meckling, 1976). Accordingly, an emerging problem is the influence of board characteristics and corporate governance on the performance of organisations. It is noteworthy to research on the mentioned area since there is a dearth of studies prevailing in this area for manufacturing industry in the context of Sri Lankan economy. Based on this background, this study conducted with two objectives in hand. First objective is to measure the level of corporate governance in terms of board characteristics and financial performance. Second objective establishes to examine the association between board characteristics and financial performance.

2. Literature Review

This section presents the concepts used in the research, theories which build the relationship between concepts and empirical evidences of selected research area.

2.1 Review on theories of Corporate Governance

Good governance is vital for every aspect of the society and it supports to improve the faith and confidence of general public. At the face of limited resources, good governance helps to promote the welfare of the society (Aras & Crowther, 2008). Under the wings of governance, corporate governance become prominent in most economies. Corporate governance is defined as "system by which companies are directed and controlled" by Cadbury (1992). The organization for Economic Co-Operation and Development (OECD, 1999) defines corporate governance as, "a group of relations, which organizes the framework among executive management, board of directors, stockholders and other related individuals".

After the first adaptation from Anglo- Saxon model, Sri Lankan corporate governance code has been undergone many reforms for the improvement of integrity, accountability, transparency and efficiency of the code (Senaratne &

Gunaratne 2009). Being in line with Cadbury (1992) of UK, Institute of Chartered Accountants of Sri Lanka developed its first code of best practice on corporate governance on 1997 covering only the financial aspects bearing the title of "Code of Best Practice on matters related to financial aspects of Corporate Governance". Later, new code was introduced by ICASL and SEC (Securities Exchange Commission) together and this code was incorporated in Colombo Stock Exchange listing rules.

Cadbury (1992, p. 14) mentioned that, "board of directors are responsible for the governance of their companies" which implies that board of directors are the pilots of corporate governance mechanism. Moreover, "the responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship" (Cadbury 1992, p. 14). With above facts, it is evident that board of directors are the execution agents of corporate governance on behalf of its shareholders and thereby responsible for financial performances.

2.2 Theories Link between Corporate Governance and Financial Performances

According to Jensen and Meckling (1976) agency relationship is a contract between owners and managers. Under this contract, owners delegate their power of decision making to managers and hence create the separation of ownership and management (Al-Shammari & Al-Sultan, 2010). Within this separation, conflict of interest can arise since both parties urge to maximize their benefits. This conflict of interest cause to the "agency problem" which results in agency cost ultimately (Jensen & Meckling, 1976). One of the best ways to reduce the agency cost is the behavior of board of directors. Effective corporate governance reduces "control rights" of shareholders on managers by increasing the probability that managers invest in positive NPV projects (Shleifer & Vishny, 1997) which ultimately leads to enhance performances of the organisation.

2.3 Empirical Studies on Corporate Governance and firm performances

As per Gregory and Simms (1999), corporate governance increases the firm's responsiveness to the need of society and finally improves the long-term performance. Black, Jang and Kim (2006) found a positive significant relationship between corporate governance and firm practices in various countries. Board size is an important element in making a difference in corporate performances, though extant literature was not consensus on this regard. Coles, Daniel and Naveen (2008) mentioned that higher the board size higher the firm performance. Contrary to this, Lipton and Lorsch (1992) argue that large board are less effective and it became difficult to coordinate, tackle and process strategic decisions of the organization. Mak and Yuanto (2003) who has used firms in Malaysia and Singapore as his sample, concluded that board size of 5 directors is the optimal size for an organisation to maximise it performances. Similar results found by

Palaniappan (2017) who states that board size is an important determinant of financial performances of manufacturing sector firms of India, but this association deemed to be a negative one. This finding is confirmed by Gosh (2006) who spelled out that board size exerts a negative influence on performances. Rosensetein and Wyatt (1990) suggested that higher proportion of independent directors are leaded to excess return of the organisation. However, Bhagat and Black (2002) found no significant relationship between independent directors and financial performances. Agency theory favours in separation between roles of chairperson and CEO to reduce conflicts of interest. Klein (2002) stated that CEO duality supports to increase firm performances meanwhile Rechner and Dalton (1991) mentioned that it is healthy for a firm to have one person to hold both positions of CEO and board chair to increase its performances. Vafaei, Ahmed and Mather (2015) supported the argument on board diversity has considerable impact on firm performances. Furthermore, Hoque, Islam and Azam (2009) stated out that audit committee meetings and remuneration committee meetings has positive relationship with firms' ROE and ROA. Another interesting finding stated by Senanayake & Ajward 2017. As per their findings, existence of nomination committee has positively significant relationship with firm performances of firms in hospitality sector in Sri lanka.

Evident from extant literature, it is noticeable that, board size, board independence, board meetings, CEO duality, women representation in the board, existence of nomination committee are commonly used hence those characteristics have been selected to use in the study. ROA and ROE are selected as proxies for firm performances since these measures have been widely used by many empirical researches locally and internationally (Palaniappan 2017; Senanayake & Ajward 2017; Ghosh 2006)

The extant literature on board composition and firm performances are inconclusive. Results provided by various studies are mixed. Therefore, examination on the problem of board characteristics and firm performances is important with special reference to the manufacturing sector of Sri Lanka. Moreover, it was noted that there is a dearth on the association exists between board characteristics and firm performances in manufacturing firms of Sri Lanka. Therefore, the study is expected to contribute to the prevailing gap observed.

3. Methodology
This section provides information on research approach, population and sample, conceptual diagram, hypothesis and operationalization.

3.1 Research Approach
Similar to extant literature, the study used the quantitative research approach to investigate the hypothesized association (Palaniappan G. 2017; Senanayake & Ajward 2017; Klein 2002).

3.2 Population, Study Sample and Data Collection Method

The population consists of all the manufacturing companies listed in Colombo Stock Exchange as at 31st March 2017. 38 companies have been registered for this date and 10 companies have been removed due to non-availability of data and mismatching financial periods (financial period ended at 31st December). Thereby, 28 companies have been selected for the study sample. The total firm –year observations are 112 since the study has collected information over four years period (2014 – 2017). All the information is collected from annual reports of selected companies under the content analysis.

3.3 Conceptual Framework

Based on the comprehensive literature survey following conceptual framework has been developed.
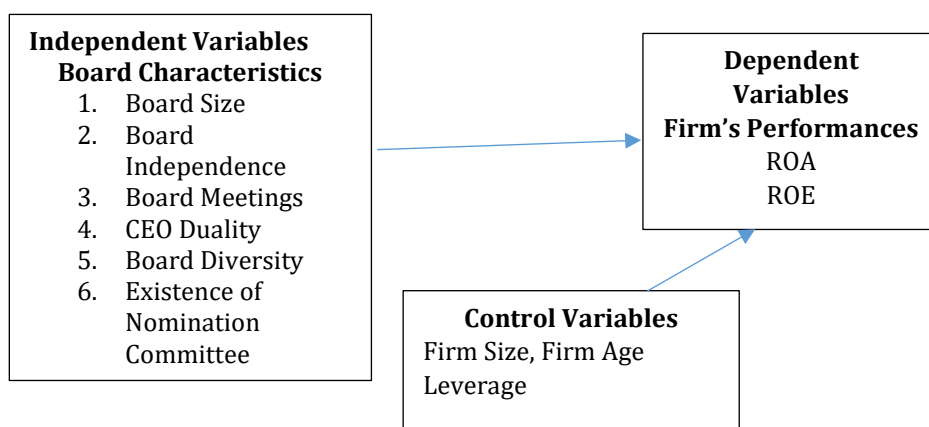

Independent Variables
Board Characteristics
1. Board Size
2. Board Independence
3. Board Meetings
4. CEO Duality
5. Board Diversity
6. Existence of Nomination Committee

Dependent Variables
Firm's Performances
ROA
ROE

Control Variables
Firm Size, Firm Age
Leverage

Figure 1: Conceptual Framework

3.3 Operationalization

Table 1 elaborates the operationalisation of each variable used in the study.

3.4 Hypotheses

From the extant literature, following hypothesis were developed.

H1: Board size has an association with firm's performances (ROE / ROA)
H0: Board size does not have an association with firm's performances (ROE / ROA)

H2: Board Independence has an association with firm's performances (ROE / ROA)
H0: Board Independence does not have an association with firm's performances (ROE / ROA)

Table 1: Operationalization

Variable Type	Variable Name	Measurement	Related Studies
Independent	Board size ($BODSIZE_{i,t}$)	number of directors on the board for the firm i and period t.	Frias-Aceituno, Rodriguez-Ariza and Garcia-Sanchez (2013)
	Board independence ($BODIND_{i,t}$)	proportion of independent nonexecutive directors on the board	Al-Shammari and Al-Sultan (2010)
	Number of board meetings ($BODMEET_{i,t}$)	Number of board meetings held per year for firm i and period	Fuente, García-Sanchez and Lozano (2017)
	CEO Duality ($DUAL_{i,t}$)	Coded as '1', if CEO and chairman roles are separated, and '0' otherwise, for firm i and period t.	Fathi (2013)
	Proportion of women directors ($DIVERSITY_{i,t}$)	Proportion of female directors on board for for firm i and period t	Mapparessa, Bakry, Totanan, Mile and Arumsari (2017)
	Existence of nomination committee ($ENC_{i,t}$)	Coded as '1', if nomination committee exists and '0' otherwise, for firm i and period t.	Senanayake and Ajward (2017)
	Return on Assets ($ROA_{i,t}$)	Calculated as: $\dfrac{\text{Net Income + interest Expense}}{\text{Total Assets}}$	Senanayake and Ajward (2017)
Dependent	Return on Equity ($ROE_{i,t}$)	$\dfrac{\text{Net Income}}{\text{Shareholders 'Equity}}$	Vafaei, Ahmed and Mather (2015)
Control Variables	Firm size ($SIZE_{i,t}$)	Natural logarithm of total assets for the firm i and the end of period t.	Kuzey and Uyar (2017
	Firm age ($AGE_{i,t}$)	Number of years from incorporation for the firm i and until the end of the period t	Bhatia and Tuli (2017, p. 330)
	Leverage ($LEVER_{i,t}$)	Total debt / Total equity	O'connel and Cramer (2010)

H3: Board meetings has an association with firm's performances (ROE / ROA)
H0: Board meetings has an association with firm's performances (ROE / ROA)

H4: CEO Duality has an association with firm's performances (ROE / ROA)
H0: CEO Duality does not have an association with firm's performances (ROE / ROA)

H5: Board diversity has an association with firm's performances (ROE / ROA)
H0: Board diversity does not have an association with firm's performances (ROE / ROA)

H6: Existence of nomination committee has an association with firm's performances (ROE / ROA)
H0: Existence of nomination committee does not have an association with firm's performances (ROE / ROA)

3.5 Analytical Strategies

Descriptive statistics of variables will be calculated in order to achieve the first objective of the research; measure the level of corporate governance in terms of board characteristics and firm's performances. Central tendencies and dispersion in relation to above mentioned variables will be presented under this analytical strategy. Correlation and multivariate regression analysis will be performed to achieve the second objective, i.e., assessing the relationship between board characteristics and firm's performances. Since the study uses panel data, panel regression will be used to achieve the same objective by controlling fixed and random effects. Statistical analysis package of Stata 12.0 used in the study to execute aforesaid strategies. Model 1 for ROA and Model 2 for ROE are developed as follows:

$$\text{ROA}_{i,t} \,/\, \text{ROE}_{i,t} = \propto + \beta_1 \text{BODSIZE}_{i,t} + \beta_2 \text{BODIND}_{i,t} + \beta_3 \text{BODMEET}_{i,t} + \beta_4 \text{DUAL}_{i,t} + \beta_5 \text{DIVERSITY}_{i,t} + \beta_6 \text{ENC}_{i,t} + \beta_7 \text{SIZE}_{i,t} + \beta_8 \text{AGE}_{i,t} + \beta_9 \text{LEVER}_{i,t} + \varepsilon_{i,t}$$

4. Findings and Discussion

This section includes the findings of aforesaid analytical strategies followed by a relevant discussion. Missing data analysis has performed and no major missing values identified which leads to biasness. All the outliers have been treated through winsorization at 0.1 level. Diagnostic tests included normality, multi-collinearity, heteroscedasticity and linearity were performed and no significant anomalies observed.

4.1 Descriptive Statistics

As shown in table 2, average of ROA is 0.10 and ROE 0.126 which possess a considerable standard deviation. This represents the differences prevails in ROA and ROE among companies in the manufacturing sector. Average number of directors for the selected period and selected sector is 8 and maximum recorded as 15. Mean value of board independence is 73.8% which found to be an impressive as per the code of best practice. Number of board meetings also shows an average of 6.5 which is far above the standards of best practice code. One of the significant variables found to be is CEO duality which is ¼ of observations and contrary to code of best practices where recommends and motivates the duality. Female representation on the board is very low in the manufacturing sector which recorded as 6.1%. All most all the companies in manufacturing sector possess

nomination committee. Average size of manufacturing firm is 21 and average age from incorporation is 36 years. Leverage recorded to be 39.2% on average.

Table 2: Descriptive Statistics

Variables	N*	Mean	SD	Min	Max
Dependent Variables					
ROA (ROA $_{i,t}$)	112	.108	.09	-.143	.568
ROE (ROE $_{i,t}$)	112	.126	.141	-.411	.584
Independent Variables					
Board Size (BODSIZE $_{i,t}$)	112	8.232	2.114	3	15
Board Independence (BODIND $_{i,t}$)	112	.738	.176	.25	1
Board meetings (BODMEET $_{i,t}$)	112	6.509	3.238	2	14
CEO Duality (DUAL $_{i,t}$)	112	.25	.435	0	1
Diversity (DIVERSITY $_{i,t}$)	112	.061	.091	0	.333
Existence of Nomination Committee (NOMIN $_{i,t}$)	111	.991	.095	0	1
Control Variables					
Size (SIZE $_{i,t}$)	112	21.581	1.142	19.146	24.525
Age (AGE $_{i,t}$)	112	36.679	16.648	1	85
Leverage (LEVER $_{i,t}$)	112	.392	.165	-.08	.815

* Sample of 28 companies

4.2 Correlation Analysis

The Table 2 shows the results of correlation analysis. In fact that, there is a significant strong positive association between (ROA $_{i,t}$) and *(ROE $_{i,t}$)* of the companies. Further, board size (BODSIZE $_{i,t}$) board independence (BODIND $_{i,t}$) and board meetings (BODMEET $_{i,t}$) show no significant association between two performance matrix of ROA and ROE. On the other hand, in both cases there is a significant weak positive association with CEO Duality (DUALITY $_{i,t}$) and significant negative association between leverage (LEVER $_{i,t}$) of the company. No association can be found between firm's performances with women on the board (DIVERSITY $_{i,t}$), existence of nomination committee (ENC $_{i,t}$), company size (SIZE $_{i,t}$), and the age (AGE $_{i,t}$).

Table 3: Correlation Analysis

Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
(1) ROA $_{i,t}$	1.00										
(2) ROE $_{i,t}$	0.76*	1.00									
(3) BODSIZE $_{i,t}$	0.02	0.07	1.00								
(4) BODIND $_{i,t}$	0.11	0.10	0.11	1.00							
(5) BODMEET $_{i,t}$	0.10	0.13	-0.04	0.00	1.00						
(6) DUALITY $_{i,t}$	0.26*	0.26*	-0.12	-0.31*	-0.21	1.00					
(7) DIVERSITY $_{i,t}$	-0.06	-0.10	-0.45*	-0.57*	0.26*	0.14	1.00				
(8) ENC $_{i,t}$	0.13	0.14	-0.07	-0.02	0.05	0.06	-0.07	1.00			
(9) SIZE $_{i,t}$	0.03	0.10	0.25*	0.24	0.44*	-0.45*	-0.12	-0.08	1.00		
(10) AGE $_{i,t}$	-0.09	-0.08	-0.32*	0.20	-0.02	0.19	-0.01	0.13	0.09	1.00	
(11) LEVER $_{i,t}$	-0.39*	-0.30*	0.22	-0.04	0.12	0.15	-0.00	-0.06	0.25*	-0.03	1.00

For the sample of 28 firms

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

4.2 Regression Analysis

The following tables (Table 4 and 5) show the OLS linear regression and panel regression analysis of the two dependent variables.

Table 4: Regression Analysis

Models	*ROA* (Model 1)			*ROE* (Model 2)		
	Coeff.	**Std. Error**	**VIF**	**Coeff.**	**Std. Error**	**VIF**
$BODSIZE_{i,t}$	0.002	0.004	1.69	0.004	0.008	1.69
$BODIND_{i,t}$	0.025	0.041	1.88	-0.001	0.075	1.78
$BODMEETi_{i,t}$	0.002	0.002	1.48	0.004	0.003	1.35
$DUALITY_{i,t}$	-0.016	0.013	1.64	-0.030	0.023	1.56
$DIVERSITY_{i,t}$	0.004*	0.083	2.26	-0.072	0.150	2.26
$ENC_{i,t}$	0.063*	0.047	1.07	0.121*	0.085	1.06
$SIZE_{i,t}$	-0.001	0.007	1.95	0.001	0.012	1.94
$AGE_{i,t}$	0.000	0.000	1.43	0.000	0.001	1.43
$LEVER_{i,t}$	-0.149***	0.036	1.23	-0.210***	0.065	1.21
F Value	3.587***			2.633***		
Adjusted R^2	24.2%			19.2%		
Prob > chi2	0.000			0.000		
N	112			112		

For the sample of 28 firms

*$p<0.1$; **$p<0.05$; *** $p<0.01$

According to the multivariate analysis in Model, women on board *(DIVERSITY $_{i,t}$)* and existence of nomination committee *(ENC $_{i,t}$)* showcase a 5% significant impact on ROA. Moreover, leverage of the company shows the 1% significant negative impact on the ROA. However, other variables show no significant impact on ROA. Based on the results obtained for ROE (Model 2), existences of nomination committee *(ENC $_{i,t}$)* and leverage *(LEVER $_{i,t}$)* indicate an impact on ROE and which is significant at 5% level.

As an additional analysis, the panel regression was carried out on the two dependent variables and results shown in Table 5. Panel regression showcases similar results to OLS regression analysis. The Model 1 of panel regression shows that there is no significant impact between ROA with selected board characteristics. However in both cases leverage (LEVER $_{i,t}$) shows significant impact on ROA and ROE. Even though, individual governance variables are not significant under model 1, existence of nomination committee (ENC i,t) appeared to have significant association with ROE in Model 2. Each and every model is statistically significant (p>chi = 0.000) in the regression analysis. Thus, statistics prove that all four models are valid and eligible for predictions.

Table 5: Panel Regression Analysis

Models	*ROA* (Model 1)		*ROE* (Model 2)	
	Coeff.	Std. Error	Coeff.	Std. Error
$BODSIZE_{i,t}$	-0.004	0.005	-0.004	0.010
$BODIND_{i,t}$	0.042	0.070	0.036	0.125
$BODMEET_{i,t}$	0.002	0.003	0.004	0.005
$DUALITY_{i,t}$	-0.009	0.022	-0.012	0.040
$DIVERSITY_{i,t}$	-0.016	0.143	-0.095	0.256
$ENC_{i,t}$	0.052	0.034	0.083*	0.063
$SIZE_{i,t}$	0.006	0.011	0.016	0.019
$AGE_{i,t}$	0.000	0.001	-0.001	0.001
$LEVER_{i,t}$	-0.155***	0.040	-0.239***	0.074
Adjusted R2		22%		16.66%
Prob > chi2		0.00		0.000
N		112		112

*p<0.1; **p<0.05; *** p<0.01

As indicated by descriptive statistics, average number of directors in the manufacturing sector is 8 which observed to be similar to the findings of De Silva, Manawaduge and Ajward (2017) who have done a research on corporate governance found out that average number of board members in Sri Lankan listed firms are eight. However, this finding observed to be less than extant literature that suggest eleven members on board. Fuente et al. (2017). Average board independence found to be 74% while extant literature suggests 51% among US firms by Al-Shaer and Zaman (2016). Comparatively, level of independence is high in manufacturing sector of Sri Lanka. Descriptive statistics indicates approximately 7 board meetings per annum which is similar to findings of De Silva, Manawaduge and Ajward (2017) who recorded six meetings. Surprisingly, only 25% of CEO duality noticed in the manufacturing sector and this is far below compared to extant literature. Chau and Gray (2010) reported 54% of CEO duality for a sample size of 298 in Hong Kong and according to Allegrini and Greco (2013), CEO duality among US company is comparatively high. Manufacturing sector of Sri Lanka possess only 6% of female directors on board and this is quite low compared to

other South Asian Countries such as Bangladesh where it is 17.38% among non-finance listed companies (Muttakin, Khan & Subramaniam, 2015).

Existence of nomination committee seems to have significant and positive impact on both ROE and ROE in OLS regression as well as in panel regression. This finding is consistent with the findings of Senanayake and Ajward (2017) who investigated the relationship with board characteristics and firm's performances in hospitality sector, Sri Lanka. Further board diversity has significant positive impact on firm performance. Contrary to this finding, Jermias and Gani (2014) found out a negative association between gender diversity and performances. However, the association between female directors on firm's performances is highlighted in the study of Senanayake and Ajward (2017) and Vafaei, Ahmed and Mather (2015) who stated out that female directors are important to enhance firm's performances in positive. As indicated by the results of the study, well diversified board is important factor to firm's performances However, the study findings regarding to leverage which recorded a significant negative relationship with firm's performances are contrary to the findings of Palaniappan (2017) who concluded his study with no significant relationship between leverage and firm's performances. Insignificant relationships between board size, board independence, CEO duality and firm performances are consistent with the results of Senanayake and Ajward (2017), who were unable to find a significant association among aforesaid variables in hospitality sector in Sri Lanka. Similary, Dalton, Catherine, Ellstrand and Johnson (1998) also could not find significant influence from independent directors on form performances. However, these finding do not agree with the findings of Palaniappan (2017), Rosensetein and Wyatt (1990), Rechner and Dalton (1991) who have concluded with significant associations between aforesaid characteristics and firm's performances.

5. Conclusion and Implications

This study aimed to investigate the influence of corporate governance in terms of board characteristics on firm's performances relevant to the context of manufacturing sector of Sri Lanka. A sample of 28 companies registered in CSE have been analysed for four years using correlation, OLS and panel regression. With the findings it was evident that no board characteristics have significant impact on firm's performances except CEO duality (under correlation analysis), board diversity, and existence of nomination committee. Leverage is the only variable which has significant negative impact on firm's performance under the set of control variables used. Thereby, all the hypotheses are rejected except hypothesis 4, 5 and 6. There are several implications arisen from study and contribute to development of corporate governance practices in Sri Lanka. Specially, policy makers could take necessary actions to enhance level of CEO duality, women participation to board in manufacturing sector of Sri Lanka as their average levels are significantly low. According to agency relationship, board characteristics are expected to have a positive impact of board characteristics on firm's performances,

although the study failed to prove the same. These finding may stimulates policy makers to seek possible causes for this relationship and use them to strengthen the corporate governance guidelines which eventually pave path to enhance firm's performances. This study has certain limitations as the study limits only to manufacturing sector and not considered private limited corporations due to convenience of access to reliable information. Future research can widen the scope by considering all the companies listed in CSE as well as non-listed companies.

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