
**THE EFFECT OF CORPORATE GOVERNANCE PRACTICES ON
FIRM'S PROFITABILITY: EVIDENCE FROM LISTED INSURANCE
COMPANIES IN THE COLOMBO STOCK EXCHANGE**

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Abstract

In recent years, many insurance companies in Sri Lanka encountered many corporate governance issues due to conflicts of interest between a company's management and its shareholders. However, only a few studies investigate the effect of corporate governance practices on the firm's profitability of the listed insurance companies in Sri Lanka. In order to fulfill this existing research gap, this study examines the effects of corporate governance practices on the financial performance of the listed insurance companies of Sri Lanka throughout 2015 – 2019. The companies' corporate governance practices are measured by using Board Size, Board Independence, Audit Committee Independence, and Managerial Ownership, while Tobin's Q, Return on Assets, Return on Equity, and the Profit Margin were used to measure the firm's profitability. The Pearson correlation analysis was used to find the association between corporate governance practices and profitability. Four random effect panel regression models were used to find the impact of the corporate governance measures on each profitability measure. The results show that the Audit Committee Independence and Board Independence positively affect profitability measures while Managerial Ownership has a negative effect on the firm's profitability. In line with the above findings, it is recommended to adopt a conservative corporate governance practice while paying greater attention to the Audit Committee Independence and Board Independence as they favorably affect the profitability of the insurance companies listed on the Colombo Stock Exchange.

Keywords: Corporate Governance Practices; Colombo Stock Exchange; Profitability; Return on Assets; Return on Equity.

Introduction

An increasing associate body of finance literature helps find the impact of corporate governance practices on financial performance. In the global context, the vast majority of empirical studies related to the impact of corporate governance practices on firms' profitability. Some studies were reporting positive impacts (Bebchuk et al., 2004; Haniffa and Hudaib, 2006; Black, 2007), and some negative reporting impact (Rui et al., 2002) with the firms' performances.

Hassan (2013) investigated that voluntary disclosure, Chief Executive Officer (CEO) duality, and board size are significantly influencing the firms' performance measured by return on assets and return on equity. This study further explains that firm size is the only control variable that

significantly influences firms' performance. This implies the corporate governance practice is an important factor in the firm profitability.

Dandago (2011) revealed that there is a significant negative relationship between board composition and board size with the return on assets, and there is a positive and significant relationship between board compositions with return on equity by investigating 17 listed Nigerian insurance companies' firms over the period of 2001 -2010. According to Andradi (2018), the Sri Lankan listed companies is moving towards practicing good governance mechanisms that firms have shown an increased interest in complying with combined code on corporate governance by maintaining two separate persons for the roles of chairman and chief executive officer and also including a greater proportion of non-executive directors in the board of directors.

Various company failures, financial scandals, and frauds occurred within the many business firms around the world suppose that effective corporate governance practices are necessary for the firm's survival. The reasons behind those cases were the absence of effective corporate governance practices within the business firms. Several empirical studies are conducted to look at the connection between corporate governance practices and firm performance worldwide. However, there's an absence in the investigation of the impact of corporate governance practices on the financial performances in the Sri Lankan listed insurance companies. Therefore, this study investigates the effect of corporate governance practices on firms' profitability of the listed insurance companies in the Colombo Stock Exchange.

Research Problem

In recent years, many insurance companies in Sri Lanka have encountered many issues regarding corporate governance practices due to conflicts of interest between a company's management and its shareholders. The decision on an effective corporate governance practice remains an imperative financial choice of insurance companies. Therefore, the effective corporate governance practices of insurance companies influence their profitability. Many research studies have been carried out to find the impact of corporate governance practices on firms' profitability. Still, only a few studies investigated the impact of corporate governance practices on the profitability of insurance companies in Sri Lanka. To fulfill this existing research gap, this study investigates the impact of corporate governance practices on the firm's profitability of all the listed insurance companies in the Colombo Stock Exchange (CSE).

Research Objectives

The study's main aim is to determine the impact of corporate governance practices on firm's profitability of the listed insurance companies in the CSE. The researcher will achieve the main objective of the study by aggregating the following specific objectives.

1. To investigate the relationship between corporate governance practices and the firm's profitability of the listed insurance companies in the CSE.
2. To investigate the impact of corporate governance practices on the firm's profitability of the listed insurance companies in the CSE.

Literature Review

Corporate governance practices can be identified as the system by which companies are directing and control (Code of Best Practice, 2008). According to Gayle (2003), corporate governance practices mean the institutional structures such as rules and regulations, laws, norms, values, and assumptions that create constraints on the behavior of a connected party.

The relationship between corporate governance practices and a firm's profitability is of interest to different stakeholders. Proof of this is the intense literature that has been developed on this subject, and it has been listed below.

Board Size

Board size is the total number of directors on the board of a specific company (Anjala 2016). It means how many numbers of directors are on the board of the organization. Anjala (2016) found that board size is positively correlated with the firm age signifying that older firms need a greater pool of knowledge and skills, which leads to the appointment of more directors to the board. This study further finds that there is a positive influence of the board size on firm performance. The main advantage has many board members: they can give constructive and valuable expert advice; however, having large boards can be ineffective due to arising free-rider problems, longer decision-making process, and significant financial burden driven by prominent directors' salaries (Bublykova, 2014). Shunu (2017) and Rashidn (2018) also suggest a substantial and positive relationship with firm performance. Appiah (2011) found that a statistically significant and positive relationship between the corporate board size and firm performance, and his findings are robust across several econometric models that deals with different kinds of endogeneities and also these results support the agency theory preposition that optimal board size improves monitoring to enhance the performance of the firm.

Some scholars find an inverse relationship between board size and financial performance (Ajay, 2007; Bublycova, 2014). This implies that a larger board size impairs the performance of the firm.

According to the above literature, the researcher has developed the following hypothesis.

H1. Board size has a Significant Impact on Financial Performance of Listed Insurance Companies in CSE.

Board Independence

Board independence can be defined as the total number of independent non-executive directors to the total number of directors (Ajay, 2007). Ajay (2007) found that different proportions of board independence have a dissimilar impact on firm performance. According to his study, the impact of board independence on firm performance is more when the board independence is between 50% and 60%.

The results of the empirical study carried out by Alessandro Zattoni (2017) showed that board independence has a marginally positive but limited impact on firm performances. Yang Pan

(2014) found that board independence has a positive impact on firm performance. These results imply that independent directors are regarded as significant monitors and advisors on boards, and the board's independence is related to higher firm performances.

According to the above literature, the researcher has developed the following hypothesis.

***H2.** Board Independence has a Significant Impact on Financial Performance of Listed Insurance Companies in CSE.*

Audit Committee Independence

Audit committee independence means that an audit committee is classified as "independent" since the majority of its members are external executives rather than internal executives. (Abbott et al., 2007). According to Koutoupis and Bekiaris (2019), when independent managers participate actively in the audit committee, the business's performance improves. According to Kallamu and Saat (2015) and Chou et al. (2013), there is a favorable relationship between the board's independence and the ROA. According to Chan and Li (2008), the board's independence has a favorable impact on company performance in the market only when the majority of its members are external.

According to the above literature, the researcher has developed the following hypothesis.

***H3.** Audit Committee Independence has a Significant Impact on Financial Performance of Listed Insurance Companies in CSE.*

Managerial Ownership

Managerial ownership means the percentage of equity owned by management and directors (Berga, 2017). The empirical study carried out by Yacine Belghitar (2011) showed that managerial ownership has a significant effect on firm performance that varies with the degree of ownership. According to the study carried out by Xing Li (2018), a positive impact exists between managerial ownership and performances of the Chinese listed companies. Zondi and Sibanda (2015) found a negative relationship between managerial ownership and performances of the listed companies in the Johannesburg Stock Exchange.

According to the above literature, the researcher has developed the following hypothesis.

***H4.** Managerial Ownership has a Significant Impact on Financial Performance of Listed Insurance Companies in CSE.*

Methods

Based on the literature review, a conceptual framework shown in Figure 01 was developed by the researcher to investigate the impact of corporate governance practices on the profitability of listed insurance companies on the CSE. Accordingly, the corporate governance practices are taken as the independent variable and measured it using the most commonly used capital structure indicators such as Board Size (BS), Board Independence (BI), Audit Committee Independence (AI), and Managerial Ownership (MO). The dependent variable of this study was

the firm's profitability, and it was measured by using Tobin's Q (TQ), Return on Assets (ROA), Return on Equity (ROE), and Profit Margin (PM). In addition to the independent and dependent variables, the researcher has used Liquidity (LQ), Leverage (LV), and Firms Size (FS) as the control variables of the research study.

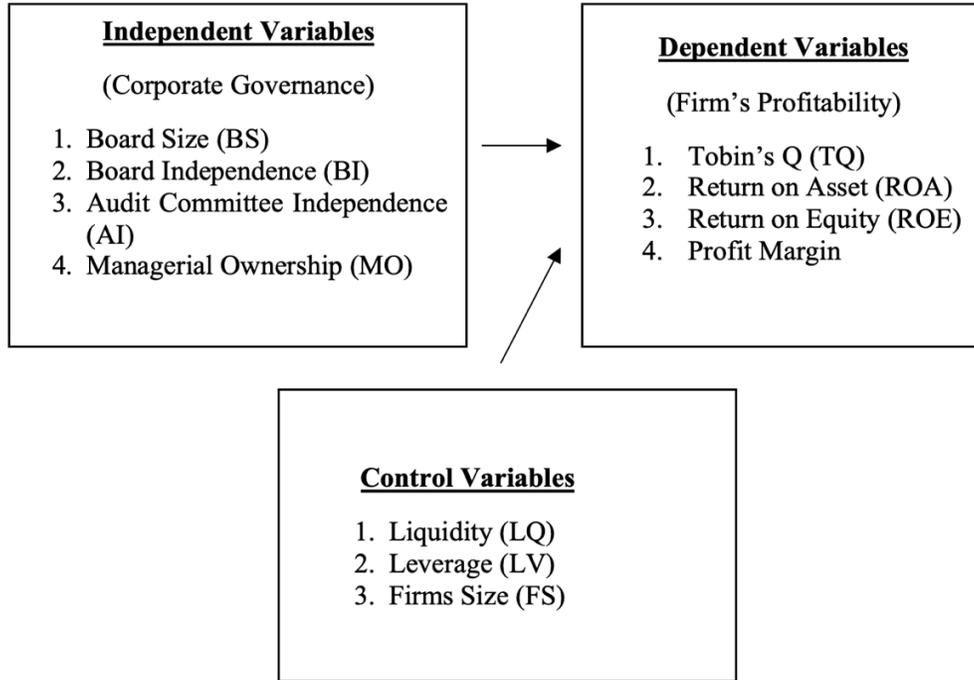


Figure 01: The Conceptual Framework of the Research Study

The functional form of the variable relationship is provided in the following econometrics model.

$$P_{it} = \beta_0 + \beta_1 BS_{it} + \beta_2 BI_{it} + \beta_3 AI_{it} - \beta_4 MO_{it} + \beta_5 LQ_{it} - \beta_6 LV + \beta_7 FS_{it} + \epsilon_{it} \text{ -----(1)}$$

In equation 1, P denotes a vector of performance variables such as Tobin's Q, Return on Assets, Return on Equity, and Profit Margin used by the researcher to measure the profitability of the listed insurance companies in the CSE. BS, BI, AI, and MO denote the corporate governance measures, while LQ, LV, and FS denote the control variables used in the research study. β_0 is the constant and $\beta_1 - \beta_7$ denotes the coefficient of the variables. ϵ_{it} represents the error term of the econometrics model.

The researcher has used balance panel data set, which includes ten Insurance companies for a period of five years from 2015 to 2019. The researcher used E Views statistical software package and Microsoft Excel package to analyze the gathered data as analysis tools. Pearson correlation analysis was used to investigate the relationship between corporate governance practices and profitability. Four-panel regression analyses were conducted using the model specified in equation 1 to examine the impact of corporate governance practices on profitability measures.

The Hausman test was applied to choose between the random-effect model and fixed-effect models.

Findings of the Study

Table 01 presents the results of the Pearson correlation analysis to establish the association between corporate governance practices and profitability measures. Based on the results presented in Table 01, BI and AI have a positive and significant relationship with TQ and ROE. This result is consistent with the evidence of a research study carried out by Alessandro (2007). MO has a negative and significant relationship with ROA and ROE. This result is consistent with the evidence of a research study carried out by Ajay (2007).

Table 01. Correlation Matrix

Variable	BI	BS	AI	MO	TQ	ROA	ROE	LQ	LV	FS
BI	1.000									
BS	0.751	1.000								
AI	0.331	0.536	1.000							
MO	0.590	-	0.094	1.000						
TQ		0.139			1.000					
ROA	0.413*	0.212	0.256*	0.867		1.000				
ROE	0.175	-	0.233*	-	0.321		1.000			
LQ	0.344*	0.218	0.122	-	0.177	0.705		1.000		
LV	-0.475	0.276	0.069	-	0.34*				1.000	
FS	0.318	0.137	-0.140	-	0.234	0.249	-			1.000
		0.509	0.189	0.144			0.387			
	-0.435	0.219	-0.193	0.037	0.443	-	0.239	0.285	0.335	1.000
						0.217				

* Indicates statistical significance at a 5% level of significance.

According to the Levin Lin Chu test results, p-values of all the variables are stationary at levels (at 5 percent level of significance). The Hausman tests conducted for the four-panel regression models reveal that the random-effect model best suits the data set. The results of four random effect panel regression models for each of the profitability measures are presented in Table 02. All the four models used in this study are statistically significant at a 5 percent level.

Table 02: Results of Random Effect Panel Regression Models

	TQ Model 01	ROA Model 02	ROE Model 03	PM Model 04
C	-17.03	-.303	-1.22	-1.17
BI	7.29	0.11*	0.35*	0.29
BS	0.04	-0.03	-0.09	-0.01
AI	3.79*	0.09*	0.21*	0.08
MO	-0.12	-0.04*	-0.01*	-0.05*
FS	1.97	0.04	0.18	0.20
LQ	-0.10	-0.05	-0.02	-0.01
LV	-0.08	-0.04	0.06	-0.01

*Indicates statistical significance at a 5% level of significance.

The study found that AI in terms of ROA, ROE, and TQ has a positive and statistically significant impact on the financial performance of listed insurance companies in the Colombo Stock Exchange. The results support the view that audit committee independence has a significant relationship with the financial performance of listed insurance companies in the Colombo Stock Exchange. This result is consistent with the evidence of a research study carried out by Garg (2007).

The findings of this study support that BI in terms of ROA and ROE has a positive and statistically significant impact on the financial performance of listed insurance companies in the Colombo Stock Exchange. This result is consistent with the evidence of a research study carried out by Rutledge (2016). According to the analysis, MO has a negative and statistically significant impact on ROA, ROE, and PM. This result is consistent with the evidence of a research study carried out by Zondi (2015).

The researcher developed the following four econometrics models based on the above regression results to explain the impact of corporate governance practices on the profitability of the listed insurance companies in the CSE.

Model 01

$$TQ_{it} = -17.033 + 0.729BI_{it} + 0.04BS_{it} + 3.79AI_{it} - 0.12MO_{it} + 1.97FS_{it} - 0.10LQ_{it} - 0.08LV_{it} + u_{it}$$

According to the random effect panel regression Model, 01 of the research study revealed a positive statistically significant impact of AI with the TQ of the listed insurance companies in the CSE. These findings are consistent with the investigation carried out by Garg (2007).

Model 02

$$ROA_{it} = -0.303 + 0.11BI_{it} - 0.03BS_{it} + 0.09AI_{it} - 0.04MO_{it} + 0.04FS_{it} - 0.05LQ_{it} - 0.04LV_{it} + u_{it}$$

According to the random effect panel regression Model, 02 of the research study revealed a positive statistically significant impact of BI and AI and negative statistically significant impact

of MO with the ROA of the listed insurance companies in the CSE. These findings are consistent with the investigation carried out by Zondi (2015).

Model 03

$$ROE_{it} = -1.22 + 0.35BI_{it} - 0.09BS_{it} + 0.21AI_{it} - 0.01MO_{it} + 0.18FS_{it} - 0.02LQ_{it} + 0.06LV_{it} + u_{it}$$

According to the random effect panel regression Model, 03 of the research study revealed a positive statistically significant impact of BI and AI and a negative statistically significant impact of MO with the ROE of the listed insurance companies in the CSE. These findings are consistent with the investigation carried out by Zondi (2015).

Model 04

$$PM_{it} = -1.17 + 0.29BI_{it} - 0.01BS_{it} + 0.08AI_{it} - 0.05MO_{it} + 0.20FS_{it} - 0.01LQ_{it} - 0.01LV_{it} + u_{it}$$

According to the random effect panel regression Model, 04 of the research study revealed a negative statistically significant impact of MO with the PM of the listed insurance companies in the CSE. These findings are consistent with the investigation carried out by Zondi (2015).

Conclusion

This study investigated the impact of corporate governance practices on the profitability of listed insurance companies on the CSE. The study results show that BI and AI have positive impacts, while MO negatively impacts the profitability of the Sri Lankan insurance companies listed on the CSE. BS has no significant impact on the profitability of the listed insurance companies in the CSE. These findings imply that a conservative corporate governance strategy is more appropriate for insurance companies while paying greater attention to the management of BI and AI as they favorably affect the companies' profitability.

Recommendation

This study considers all the insurance companies listed on the CSE for five years from 2015-2019. Future researchers can further investigate the impact of corporate governance practices on profitability by increasing the research study period and increasing the sample amount by developing research to another non-finance industry or developing the investigation beyond the country level. Further, many of the studies applied quantitative research methods to determine the impact of corporate governance practices on profitability. Future researchers may use qualitative methods such as interviewing the managers of the relevant business firms. This would help develop knowledge related to the firm's corporate governance and help maintain effective corporate governance practices within the organization to increase the firm's value.

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