

An Empirical Study on Corporate Governance Structure and Performance of Sri Lankan Listed Financial Services Companies

DH Dilrukshi Nadeesha *

* Institute of Human Resource Advancement, University of Colombo

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Abstract-

With the rapid growth of financial service sector and past experience of distress of financial service companies in Sri Lanka, this study motivates to investigate the relationship between the corporate governance structure and performance of 59 listed financial service companies in Colombo Stock Exchange during the period of 2014-2017. Tobin's Q and Return on Assets are used as financial performance measures. Our findings show that managerial ownership is significantly associated with the market performance measure but not with accounting performance measure. This negative relationship of managerial ownership with market based performance which suggests a managerial entrenchment effect where the management further their own self-interests rather than firms' goals in the financial service industry. The results are consistent with the agency theory where managers are unlikely to maximize returns to shareholders. In addition, the study found that there is an insignificant relationship between other governance measures and the performance. The result is robust with respect to controls for gearing and company size.

Key Words- *Corporate Governance, ASPI, Corporate Performance, Managerial Entrenchment, Board Characteristics*

I. INTRODUCTION

The corporate governance structure and firm performance has been a topic of considerable debates in the academic and business communities. An effective governance system is important as it promotes the efficient use of resources both within the firm and the economy, also assisting firms and economies in attracting lower-cost investment capital via the improved confidence of investors and creditors, both domestically and internationally. Also, it helps in increasing the responsiveness of firms to societal needs and expectations and in improving the long-term performance of firms. In other words, corporate performance is presumably reflected in the way the firm is managed as well as the efficacy of the firm's governance structure (Haniffa and Hudaib, 2006)

The theoretical motivation for undertaking the study on the effect of corporate governance and firm performance is to enhance the efficacy of governance structures undertaken by developed countries via the establishment of Corporate Governance Guidelines (e.g. the Cadbury, Hampel and Higgs Reports in the UK, the Bosch Report in Australia and the Business Roundtable in the US) following major corporate collapses in various developed stock markets in the last two decades (Khas, 2002). The Institute of Chartered Accountant of Sri Lanka has been at the forefront of issuing Corporate Governance Codes in Sri Lanka. The first titled "Code of Best Practice on matters related to financial aspects of Corporate Governance" was issued in 1997.

The International Monetary Fund (IMF) revealed that out of the 46 licensed financial companies in Sri Lanka, 15 are presently facing liquidity issues, with six at a high level of distress with Non-Performing Loans ranging from 50 to 90 percent (Razak, 2016). Further, IMF highlighted that the mismanagement and irregular practices, the rapid growth of the non-bank financial sector in Sri Lanka has often led to excessive risk taking which has led to the weakening of the financial position of these companies. There is a main concern regard to the compulsory listing requirement for registered finance companies introduced by the previous administration. However, The 12 finance companies not listed on the Colombo Stock Exchange but operating at present in the finance industry (Razak, 2016). Therefore, main motivation of the current study is to explore whether the various best governance practices influence performance of Sri Lankan listed banking and finance corporations listed in Colombo Stock Exchange (CSE). As a result, core issue in the corporate governance system is the nature of the relationship between the practice of best code of ethics in corporate level and economic performance of a financial service firm. It was concluded that macro economy and share market performance were the two most

appropriate concepts for this study. Accordingly, the main objective of the study is to investigate the relationship of corporate governance system and firm performance of public financial service companies listed in CSE.

1.1.1 Colombo Stock Exchange

The CSE has two main price indices called All Share Price Index (ASPI) and Standard and Poor Index (S&P). Index values are calculated on an on-going basis during the trading session, with the closing values published at the end of each session. The CSE has 295 companies representing 20 business sectors as at 30th September 2017, with a Market Capitalization of Rs. 2,919 Billion in 2017(2018a). Public Companies incorporated under the Companies Act No.7 of 2007 or any other statutory corporation, incorporated or established under the laws of Sri Lanka or established under the laws of any other state (subject to Exchange Control approval) are eligible to seek a listing on the CSE to raise Debt or Equity from public. In order to secure a listing of the company's securities, they will be required to comply with the relevant provisions of the above act, the Securities and Exchange Commission Act No.36 of 1987 (as amended) and the Listing Rules of the Exchange (2018b)

1.1.2 Sector Indices

CSE holds 20 sector indices. These sector indices are calculated based on an on-going basis and closing values are published at the end of trading daily. These price indices reflect the price movements of companies in the 20 respective service sectors. The sector price indices will therefore be an indication as to the trends of the market. The Table 1.1 represents the market capitalized percentage of index covered by ASPI in 2018(2018a).

Table 1.1 Sector Index as a Market Capitalized Percentage of ASPI

SECTOR	% of ASPI	Cumulative %
BANKS, FINANCE & INSURANCE	22%	22%
DIVERSIFIED HOLDINGS	21%	43%
BEVERAGE, FOOD & TOBACCO	20%	63%
HOTELS & TRAVELS	9%	72%
TELECOMMUNICATION	6%	78%
MANUFACTURING	5%	83%
OIL PALMS	4%	87%
HEALTH CARE	2%	89%
CONSTRUCTION & ENGINEERING	2%	91%
LAND & PROPERTY	2%	92%
INVESTMENT TRUSTS	1%	94%
POWER & ENERGY	1%	95%
TRADING	1%	96%
PLANTATIONS	1%	97%
MOTORS	1%	98%
CHEMICALS & PHARMACEUTICALS	1%	99%
FOOTWEAR & TEXTILES	0%	99%
SERVICES	0%	100%
STORES & SUPPLIES	0%	100%
INFORMATION TECHNOLOGY	0%	100%
ASPI	100%	

Source: www.CSE.lk, 2018

As shown in Table 1.1, 22% of the market capitalization covered by Banking, Finance and Insurance sector in ASPI. This weighting system allows the price movements of above mentioned industries to have a greater impact on the index.

THEORETICAL BACKGROUND, PRIOR RESEARCH AND HYPOTHESES

It is generally accepted that strong corporate governance structures are essential to mitigate the 'agency' problem that arises due to the separation of ownership and control in firms. Empirical evidence indicates that the size of the board does matter (Monks and Minow, 1995) as it affects the extent of monitoring, controlling and decision making in a company. Jensen and Meckling (2009) explain the agency relationship which is a contract under one party (the principal) engages another party (the agent) to perform some service on their behalf. Managers as agents acting in their own self-interest are unlikely to maximize returns to shareholders. Therefore, an appropriate governance structures should be implemented to safeguard the interests of the investors.

Small boards are supposed to support in alleviating the effort problem and in becoming more effective (Daily et al., 2003); and (Ghosh, 2006), but when they grow too big, boards become more symbolic rather than being a part of the management process (Hermalin and Weisbach, 2000). However, bigger boards may be constructive for some companies as they provide diversity that would help companies to secure critical resources and reduce environmental uncertainties (Pombo and Gutiérrez, 2011); (Haniffa and Hudaib, 2006). Martin and Jay (1992) recommend that board membership to be between eight and nine, and any additional benefits from increased monitoring gained by additional membership will outweigh the costs associated with slow decision making, the effort problem and easier control by the CEO (John and Senbet, 1998). Based on the literate review, the study developed below hypothesis.

H1: Higher the board size diminishes the corporate performance.

Empirical evidence on the count of Non – Executive Directors (NEDs) which impact on corporate performance is mixed. Millstein and MacAvoy (1998) found US corporations with a higher proportion of active independent boards perform much better than those with passive, non-independent boards. In contrast, Singh et al. (2018) found a significant negative relationship between board outsiders and firm performance based on Tobin's Q. Rhoades et al. (2000), using meta-analysis, found a weak link in performance when there is dominance of either insiders or outsiders on the board as opposed to a balanced board. Leung et al. (2014) and Zattoni et al. (2017) found a non-significant relations between corporate performance and the proportion of outside directors. Based on the empirical studies, the hypothesis developed as;

H2: There is a non-significant relationship between the proportion of NEDs on the board and corporate performance.

Empirical analyses of the impact of role duality on various corporate performance measures have yielded conflicting results. Boyd (1995) found evidence of better performance for US firms with role duality. However, Rhoades et al. (2000) found firms with a separation of the two roles consistently have higher accounting returns compared to those that have the roles combined. Based on the Australian study of Christensen et al. (2010), there are conflicting significant results between the accounting and market measures for having a dual CEO/chairperson. In contrast, Peel and O'Donnell (1995) and Dahya et al. (1996) found no significant difference in the performance of companies with or without role duality. The UK studies by Weir et al. (2002) also came to the similar conclusion of difference in the firm performance due to role duality.. Brickley et al. (1997) found no systematic link between duality status and organizational performance or market value. Hence the next hypothesis is;

H3: There is a non- significant relationship between role duality and corporate performance.

According to Managerial entrenchment theory, the incentive to maximize firm value declines as market discipline becomes less effective against a larger shareholding manager as management increases its ownership. Weir et al. (2002), (Short and Keasey, 1999) confirm that UK management become more entrenched in ownership than their US counterparts. Second, the results from extending the analysis to consider different measures of firm performance and a more generalized form of the relationship confirm the general finding of the US literature of a non-linear relationship between firm performance and managerial ownership. Cui and Mak (2002) examines relationship between managerial ownership and performance for R&D firms that are listed on the NYSE, AMEX and NASDAQ. This study found a W shaped relationship between managerial ownership and performance where Tobin's Q initially declines with managerial ownership, then increases, then declines again and, finally, increases again. Also, this relationship explain with industry effects in determining relationship between managerial ownership and performance of the firm. Levana Dhia and Martinus Hanung (2016) proves that managerial ownership negatively affects company performance with a company effect using Polynomial regression analysis method.

H4: There is a significant negative relationship between managerial ownership and corporate performance

II. RESEARCH METHODS

As at 31 December, 2017, a total of 59 financial service companies were listed on the All Share Price Index (ASPI) of the CSE. Since the study looks at the period between 2014 and 2017, the full data set, especially those data related to corporate governance variables, are available for all financial service companies and collected from the Colombo Stock Exchange website.

The independent variables consist of six corporate governance variables, namely board size (BSIZE), board composition (BODCOM), board leadership or role duality (DUAL), multiple directorships (MDIR), top five shareholders (TOP5), managerial shareholdings (MOWN), and four control variables, gearing (GEAR), company size (LNSA), capital expenditure (LNCAPEX), and industry type based on the classification of banking, insurance, finance and other financial service providers. The dependent variable is corporate performance and two measurements, namely Tobin’s Q (Q-Ratio) and return on assets (ROA), are considered in this study as proxies for market return and accounting return respectively and Table 3.1 explains operationalization of research variables.

Table 3.1. Operationalization of Research Variables

Variables	Acronym	Operationalization
Dependent Variables		
Tobin’sQ	Q- Ratio	Ratio of the market value of common shares plus total debt divided by the book value of total assets of the company.
Return on assets (%)	ROA	Earnings after tax divided by total assets of the company.
Independent Variables		
Board size	BSIZE	Total number of directors on the board of the company.
Board composition (%)	BODCOM	The proportion of non-executive directors (NEDs) to total number of directors on the board of the company.
Role duality	DUAL	Dichotomous with 1 if the chairman is also the chief executive officer (CEO) of the company and 0 otherwise.
Top 5 shareholders	TOP5	The proportion of shares owned by the five largest shareholders to total shares outstanding in the company.
Managerial Shareholdings	MOWN	The proportion of shares owned by the executive of the company as a group to total shares outstanding.
Control Variables		
Gearing (%)	GEAR	The percentage of total equity to total assets of the company.
Sales (proxy for size)	LNSA	Natural log of sales of the company
Capital expenditure (%)	CAPEX	Proportion of capital expenditure to total assets

3.1 Model Development

The study will be used the following two models to analyse the relationship between the various corporate governance variables and corporate performance:

Model 1:

$$Q\ Ratio_t = \alpha_0 + \beta_1 BSIZE + \beta_2 BODCOM + \beta_3 DUAL + \beta_4 TOP5 + \beta_5 MOWN + \sum_{i=1}^n \beta_i OTHERS + \varepsilon$$

Model 2:

$$Q ROOA_t = \alpha_0 + \beta_1 BSIZE + \beta_2 BODCOM + \beta_3 DUAL + \beta_4 TOP5 + \beta_5 MOWN + \sum_{i=1}^n \beta_i OTHERS + \varepsilon$$

where:

α - Intercept.

Q-Ratio - Tobin's Q-Ratio; proxy for market measure of performance.

ROA - Return on assets; proxy for accounting measure of performance.

BSIZE - Board size.

BODCOM - Board composition.

DUAL - Role duality; chairman of the board is also the chief executive officer.

TOP5 - Shareholdings held by top 5 major shareholders.

MOWN - Shareholdings held by directors.

Others - Control variables: gearing (GEAR), size based on natural logarithm of sales (LNSA), capital expenditure (CAPEX), and dummy variables for each of the six industry classifications.

ε - Error term.

III. FINDINGS AND DISCUSSIONS

The study considered the descriptive statistics regarding the financial service companies' dependent, independent and control variables before calculating the regressions. Table 4.1 presents the descriptive statistics for the raw data for the board characteristics in most recent period from 2014-2017 and the performance.

Table 4.1. Descriptive Statistics of Financial Performance

	Type of Financial Service Company			
	Banking	Insurance	Finance and Leasing	Investment Services
	Average	Average	Average	Average
Q-Ratio	0.917466176756234	0.900821077153888	0.968706229142736	0.025248291870760
ROA	0.89%	2.71%	8.04%	-1.64%

The measures of ROA indicate that all of the financial service companies tested performed well except Investment Services reporting a negative ROA. The highest Tobin's Q perform in Finance and Leasing companies. The mean for Tobin's Q indicating that the market value is greater than the book value of the assets. The mean ROA was 8.04 for Finance and Leasing Companies and 2.71% for Insurance Companies, indicating that the profitability of companies compared to its assets lower somewhat in Banking and Investment Service Companies.

Table 4.2. Descriptive Statistics of Corporate Governance Indicators

	Type of Financial Service Company			
	Banking	Insurance	Finance and Leasing	Investment Services
	Average	Average	Average	Average
BSIZE	10	8	9	7
BODCOM	88.91%	70.31%	85.92%	63.91%
TOP5	27.9%	23.2%	29.1%	43.8%
MOWN	0.3609%	10.9765%	0.7080%	9.1735%

Highest average board size is reported in banking and least average board size is reported in investment service companies. There is also a large managerial ownership reported in insurance companies and least managerial ownership reported from the banking sector. Highest ownership concentration is explained by the percentage of shareholdings hold by top five investors which investment service companies reported highest ownership concentration.

The estimation of multiple regression models requires the absence of multicollinearity between the performance and board structure of the finance companies tested. A serious multicollinearity problem is predicted by Arceneaux and Huber (2007) when starting at 0.7. The Pearson correlation in Table 4.3 established that there are no strong relationships between the independent variables, in conformance with Arceneaux and Huber (2007) as all correlation coefficients were lower than 0.7. No bi-variate multicollinearity existed for any of the models tested.

Table 4.3. Correlation Analysis

	BFSIZE	BODCOM	DUAL	TOP5	MOWN	GDIV	Q-Ratio	ROA	GEAR
BODCOM	0.294 0.001								
DUAL	-0.111 0.237	-0.141 0.13							
TOP5	-0.158 0.09	-0.124 0.185	0.037 0.694						
MOWN	-0.241 0.009	-0.297 0.001	0.121 0.196	-0.097 0.302					
GDIV	0.095 0.312	-0.129 0.168	0.097 0.3	0.362 0	-0.102 0.277				
Q-Ratio	-0.018 0.849	-0.003 0.973	0.037 0.695	-0.007 0.945	-0.184 0.048	0.093 0.323			
ROA	0.009 0.927	0.144 0.122	-0.054 0.567	-0.06 0.524	0.025 0.789	0.048 0.608	-0.18 0.053		
GEAR	0.303 0.001	0.131 0.16	-0.313 0.001	0.003 0.977	-0.296 0.001	0.188 0.044	0.321 0	0.048 0.612	
LNSA	0.378 0	0.252 0.006	-0.126 0.178	-0.221 0.017	-0.066 0.479	0.113 0.226	-0.107 0.255	0.298 0.001	0.409 0
LNSAPEX	0.222 0.017	0.203 0.029	-0.04 0.672	-0.344 0.000	-0.055 0.559	-0.019 0.836	0.113 0.225	-0.029 0.759	0.318 0.001

The results of correlation matrix show that there is negative relationship between Tobin Q ratio and managerial ownership ($r=-0.184$, $P<0.05$). Also, it confirms that managerial ownership shows a negative association between gearing ratio at 5% significant level. The results of the OLS regression in Table 4.4 determine whether current and future company performance (measured as Tobin's Q and

ROA) can be explained by independent and control variables for the sample selected. The main purpose in Table 4.4 is the association and the significance of the independent and control variables further tested. The regressions performed are significant at the 95% confidence level in both Tobin's Q and ROA. For Tobin's Q 30% and ROA 25% of the variation is explained by the independent and control variables.

Table 4.4. Regression Results

Dependent Variable	B	Std. Error	t	Sig.	95% Confidence Interval		Partial Eta Squared	
					Lower Bound	Upper Bound		
Q-Ratio (Model 1)	Intercept	0.892	0.316	2.822	0.006	0.266	1.519	0.067
	BODCOM	0.000	0.002	-0.164	0.870	-0.005	0.004	0.000
	BSIZE	-0.014	0.023	-0.617	0.539	-0.059	0.031	0.003
	TOP5	-3.430E-06	1.422E-05	-0.241	0.810	-3.162E-05	2.476E-05	0.001
	MOWN	-0.007	0.003	-2.039*	0.044*	-0.014	0.000	0.036
	LNCAPEX	0.013	0.012	1.143	0.256	-0.010	0.036	0.012
	DUAL	0.009	0.064	0.143	0.887	-0.118	0.136	0.000
	Gearing	0.005	0.001	3.709	0.000	0.002	0.008	0.108
	LNSales	-.026	0.016	-1.560	0.122	-0.058	0.007	0.021
ROA (Model 2)	Intercept	0.871	3.869	0.225	0.822	-6.796	8.539	0.000
	BODCOM	0.048	0.030	1.624	0.107	-0.011	0.107	0.023
	BSIZE	-0.056	0.276	-0.201	0.841	-0.603	0.492	0.000
	TOP5	-9.966E-05	0.000	-0.573	0.568	0.000	0.000	0.003
	MOWN	0.024	0.043	0.571	0.569	-0.060	0.109	0.003
	LNCAPEX	-0.102	0.143	-0.716	0.475	-0.385	0.180	0.005
	DUAL	0.073	0.783	0.094	0.925	-1.479	1.626	0.000
	Gearing	-.009	.018	-.526	.600	-.045	.026	.002
	LNSales	.580	.207	2.799	.006	.169	.990	.064

*Significance at the 0.05 level

Test results indicate a Durbin-Watson statistic of 2.19 for Model 1 and 1.9 for Model 2 which demonstrates the models fit well. The outcome reveals that Managerial ownership has a significant negative impact on Tobin's Q. With the exception of this variables, other governance attributes indicate insignificance association at 5% significance level. Although Model 1 accounts relatively lower variance, the model is significant at 1% significance level (F=20.85). Model 2 is not significant at 5% significant level (P>0.05). Additionally, the Durbin-Watson statistic which measures the autocorrelation in the residuals of the models are 2.19 in model, which indicates no serial correlation in errors of the model and ensures the model fit. Assessing the acceptance or rejection of the hypothesis will be dependent on the t-statistic being greater than the critical value of 1.96 at 95% confidence level. Further, it is interesting to explain the relationship of managerial ownership and Q Ratio graphically as shown in Figure 4.1. In order to analyze it further in a post hoc manner, the study divided managerial ownership to two stratifications as more than 20% of the proportion of shares owned by the management of the company as 1 and otherwise 0 (Fahlenbrach and Stulz, 2009).

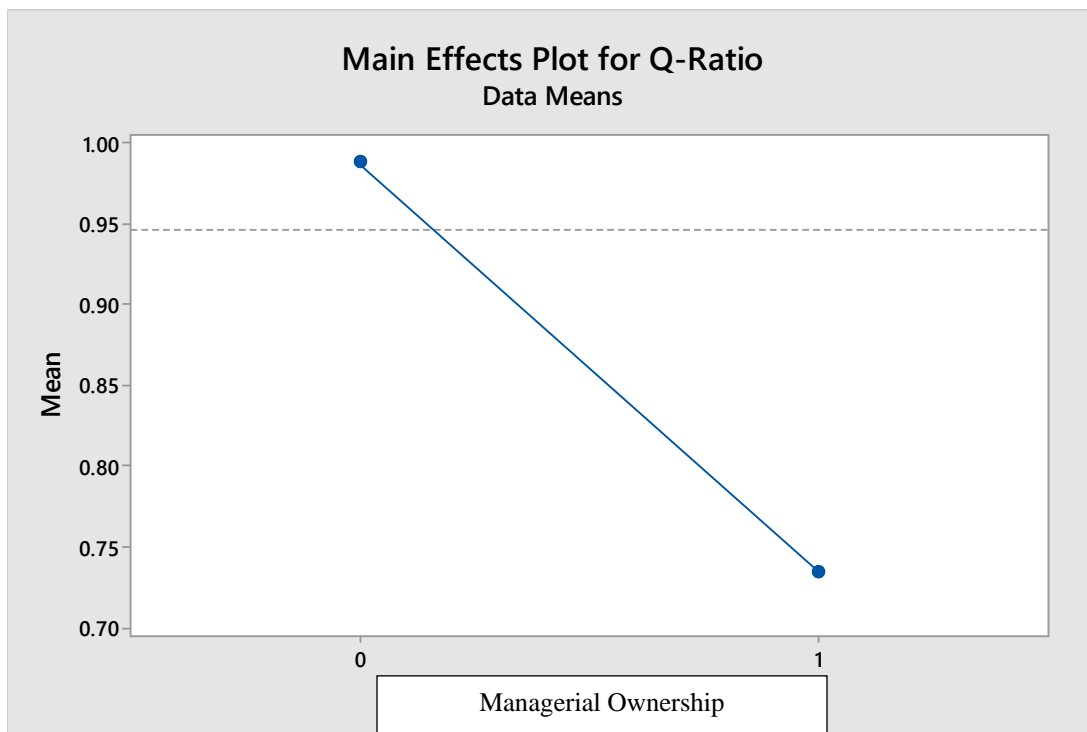


Figure 4.1. Main Effect Plot for Q-Ratio in Model 1

To test the robustness of the results, additional analysis was performed by re-testing the regression by excluding the control variables of Lnsales, Lncapex and gearing. The results obtained are consistent with the original regression performed. The multicollinearity problem underlying the regression model was tested by calculating a correlation matrix and a variance inflation factor (VIF) for each variable. The finding satisfy with all of the VIFs tested are below 2 and the only model 1 satisfy the assumptions of normality of residuals and homoscedasticity.

CONCLUSION

Contradicting the research finding of (Li X, et al, 2018), a positive relation between firm value and managerial ownership which is often viewed as evidence that higher managerial ownership increases shareholder wealth because it aligns the interests of management better with the interests of shareholders. However, our finding supports managerial entrenchment by showing a negative impact of managerial ownership on financial performance in financial service companies in Sri Lanka. This means that investors believe that managers gain so much power that they are able to use the firm resources to achieve their own interests, especially in financial service companies. This finding support (Faleye, 2007) that classified boards entrench management and reduce the effectiveness of directors, thereby hurting firm value. The finding suggests to further research the managerial entrenchment behaviour in financial service firms and governance effect on non-financial firms in listed finance companies.

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AUTHORS

First Author – DH Dilrukshi Nadeesha, BBA, MSc in Business Statistics, Institute of Human Resource Advancement, University of Colombo, Dilrukshi.hewage@ihra.cmb.ac.lk.

Correspondence Author – DH Dilrukshi Nadeesha, BBA, MSc in Business Statistics, Institute of Human Resource Advancement, University of Colombo, Dilrukshi.hewage@ihra.cmb.ac.lk.

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