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EFFECT OF BOARD SIZE ON COMPANY PERFORMANCE IN THE LISTED FINANCIAL INSTITUTIONS IN SRI LANKA

LINGESIYA YASOTHARALINGAM
LECTURER
DEPARTMENT OF FINANCIAL MANAGEMENT
UNIVERSITY OF JAFFNA
SRI LANKA

ABSTRACT

Financial institutions are generating distinct corporate governance challenges. Good Corporate Governance is essential to the effective operation of a free market, which enables wealth creation and freedom from poverty. Therefore, corporate governance has engaged the attention of academics and practitioners alike for some time now. The Securities and Exchange Commission of Sri Lanka is committed to improving and promoting the use of international best practice which is essential for the development of the capital market, improvement of professionalism among market participants and raising the profile of the Sri Lankan capital market, in keeping with its objectives. The present paper examines the relationship between the most significant corporate governance factor –that is, the size of the board of directors and firm performance on a sample of 25 listed financial institutions in Sri Lanka over the period 2008-2010. The performance of the firms is measured by return on assets (ROA). Ordinary Least Squares is applied to test the significance of board and firm performance. Results of the study reveal that financial institutions profitability is negatively related to the size of the board of directors.

KEYWORDS
Board Size, Corporate Governance, Firm Performance.

BACKROUND AND SIGNIFICANCE TO THE STUDY

"*Good Corporate Governance is essential to the effective operation of a free market, which enables wealth creation and freedom from poverty*" (Financial Reporting Council of the UK). The Central Bank of Sri Lanka reveals an economic growth of well above 6% for the third consecutive year in Sri Lanka, with a per-capita income of USD 1,617 in 2007 raising the current status of the Country from Low-income countries to Lower-middle income countries. The private sector of the economy is a large contributor to this growth. Good Corporate Governance would undoubtedly have played a leading role in achieving these impressive results.

The Institute of Chartered Accountants of Sri Lanka is indeed proud to be the pioneer in introducing good corporate governance principles to the Nation with the introduction of the 'Code of Best Practice on matters related to financial aspects of Corporate Governance' in 1997, which was later updated in 2003.

In addition to the traditional functions of the Central Bank of Sri Lanka, the Bank also performs many other regulatory functions. One such function is the Central Bank role to supervise Banks and other Financial Institutions and this function has assumed an extremely important level today. This function naturally extends to assisting Banks and Financial Institutions to improve their governance systems and their credit delivery systems, as well. In that context, the Central Bank by its supervisory function helps to improve the overall Corporate Governance procedures and practices in a key and important sector, which has a tremendous impact upon the economy of the nation. In the late 1990's, a spate of finance company failures led to adverse public reactions against the Central Bank, which culminated in several reforms being initiated. Some of these reforms were to tighten the doubtful debt provisioning methods and the more effective supervision and regulation of the conduct of Directors, especially in relation to related party transactions. The Central Bank also initiated the CRIB, i.e. the Credit Information Bureau, which today provides up-to-date information about customers who have defaulted to any one of the member banks. Through such pooling of vital credit information *via* the access to a centralized information network, the Banks in general have been able to improve their own credit delivery systems significantly.

Since of late, a few concerns have been expressed that the Central Bank has been somewhat lax in its supervision of the banking and finance company sectors, and this has resulted in some expressions of dissatisfaction within the corporate community. It is hoped that such situation would be temporary, and that the Central Bank would respond more positively towards enhancing the overall governance in the banking sector.

Banks and financial institutions have a special role in the economy of any nation. They play a critical function in mobilizing savings and allocating them to productive investment use. They also underpin the vital payments and liquidity systems on which the smooth operation of an economy is dependent.

It is a feature of banks that they are highly leveraged institutions. Shareholders typically have a small minority of total funds at stake in a bank, whereas depositors and lenders have a far greater share. The nature of banks and the pervasiveness of banking, results both in their inherent fragility, and their unique capacity for projecting the effects of their problems or collapse far beyond their corporate boundaries, often to those least able to bear the burden of distress.

The safety of the banking system is therefore, a public good. Regulators are responsible to ensure that policies are in place and are implemented, which protect the major stakeholders including depositors and shareholders, as well as the national interest. This is best achieved though a combination of effective supervision, high capital adequacy norms, healthy market competition, and good corporate governance.

Long-term relations with financial institutions can affect the performance of the corporate sector. Differences in corporate governance systems are thought to influence the cost of capital and the availability and type of financing available to firms. If the development of financial markets is linked with economic development then this can impinge upon economic growth. However, this may not matter if there are other sources of financing available to the corporate sector.

Corporate boards play a central role in the corporate governance of companies, understanding this relationship is crucial to our understanding of corporate governance (Guest, 2009). The two basic functions of the board of directors are advising and monitoring (Raheja, 2005). The advisory function involves the providing expert advice to the CEO (Fama and Jensen, 1983). Second function of the board of directors is to hire the CEO (Chief Executive Officer) and other top executives and evaluate their performance and to ensure that managers pursue the interest of shareholders (Hermalin and Weisbach, 1988). The executives are replaced incase if their performance is unsatisfactory. Performance, which shows if the resources of the firm are used efficiently to fulfill the goals of the firm (Daft, 1997), is crucial in evaluating the overall success of the firm (Parker, 2000). For performance, evaluation firms employ both financial and nonfinancial performance criteria. Financial performance measures are the starting point for most organizations' performance measures systems (Bloxham, 2002). Measures such as ROA (Return on Assets), ROE (Return on Equity) and EPS (Earnings Per Share) are financial performance measures that are most frequently used at academic research. ROA and ROE are better indicators of corporate performance because they include the balance sheet (Stern et al, 2004). In this study performance was measured by ROA

In Sri Lanka the stability and resilience of the financial system was maintained despite shocks caused by the global financial crisis and the failure of some unauthorized entities engaged in financial business. The global economic downturn and decline in world trade led to a slowdown in domestic economic growth and a significant contraction in credit expansion. Overall, the key financial institutions maintained their soundness with adequate capital levels, sustained earnings and improved risk management systems. The regulation and supervision of the banking, finance, insurance and securities sectors have been further

strengthened to improve the resilience and soundness of the financial sector. This evidences prove the strength of corporate governance practices in Sri Lanka under guidance of Central Bank of Sri Lanka.

Previous empirical studies on corporate governance concerning the Sri Lankan financial sector are limited, with the emphasis being placed upon research conducted in the Sri Lankan banking sector. The present paper assesses the relationship between the board size with measures of firm performance (accounting-based profitability) and specific variable in the Sri Lankan financial sector over the period 2008-2010. The sample consists of 25 out of the 33 financial institutions operating in Sri Lanka. Therefore, the problem statement of this study is **to what extent the size of the board of directors affect the financial performance of financial institutions in Sri Lanka?**

OBJECTIVE OF THE STUDY

The purpose of this study is to examine the relationship between board size and financial performance of the financial services organizations in Sri Lanka.

THE IMPORTANT ROLE OF THE BOARD OF DIRECTORS

According to the most recent description offered by the Organization for Economic Cooperation and Development (OECD), corporate governance "involves a set of relationships between a company's management, its Board, its shareholders and other stakeholders also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined (Adams and Mehran,2005).

The board of directors plays an important role in the operation of a company. It oversees top management and is entrusted with the responsibility of monitoring and supervising the company's resources and operation. Therefore, the board is collectively seen as a team of individuals with fiduciary responsibilities of leading and directing a firm, with the primary objective of protecting the firm's shareholders' interests (Abdullah 2004). Therefore, this study is believed to contribute to the existing body of knowledge regarding the board composition and give timely signals to investors and depositors. There are three critical board roles that have been identified and studied by a variety of theoretical perspectives inclusive of service roles, control roles and strategic roles (Zahra and Parce 1989). This has been further elaborated in a different study that the board should alternatively fill an auditing, a supervisory, a coaching, and a steering role. However, the separation between ownership and control mechanism in today's modern organization has resulted in a potential conflict of interest situation (Berle and Means 1932). This is also a consequences of the agency theory in which the self-interest of the management is likely to lead them to involve in value-decreasing activities (Jensen and Meckling, 1976). The predicted reduction in value of the firm as a result of the management opportunistic behavior is known as "agency costs" (Jensen and Meckling 1976).

Corporate Governance is aimed at ensuring that firms are operated efficiently and in the best interests of shareholders and other stakeholders such as employees, creditors, major suppliers and consumers and society at large. Corporate Governance yields considerable benefits to firms, shareholders, other stakeholders and society.

In contrast, the consequences of a poorly governed firm are often poor corporate performance, losses and collapse. The poor performance or collapse of a firm not only leads to losses, but it also has adverse impacts on society by undermining the stability of the financial system, efficient resource utilization and the competitiveness of the national economy. As such, Corporate Governance is a major issue of public policy of national importance and not limited to the narrow interests of shareholders with a direct financial stake in the firm.

Stakeholders who comprise the Government and other shareholders, customers, employees and the general public require the Board of Directors in its capacity as the agents of the owner, to safeguard the interests of the Bank by rebuilding its capital base, ensuring sustainable profitability and enhancing stakeholder value. These imperatives permeate all our activities.

The Central Bank of Sri Lanka in June 2002 issued a guideline titled "Code of Best Practice – Corporate Governance" For voluntary adoption by all Banks and Financial institutions. The Board Complies with the practices, principles and guidelines set out in the above document.

A code of Best Practice in Corporate Governance for Public Enterprises in Sri Lanka – by the Department of Public Enterprises Ministry of Finance was issued in January 2003 to serve as minimum requirements for all Government and Public Institutions in Sri Lanka.

Additionally the Institute of Chartered Accountants of Sri Lanka (ICASL) and the BASEL Committee on Banking Supervision have published Documents and guidelines on Corporate Governance.

BOARD OF DIRECTORS

The Board of Directors ensures and remains continuously committed to the establishment and implementation of the sound principles of Corporate Governance in order to safeguard the Bank, its depositors and other stakeholders, reviewing and updating the structures in line with the changing internal and external environments and best market practices prevailing in Sri Lanka.

The Board currently comprises independent, eminent leaders with distinguished backgrounds in Law Industry, Finance, the Cooperative movement and relevant professions who provide a wealth of practical experience and commercial orientation, committed to drive through the much-needed changes for the creation of a truly sustainable and independent bank.

The Board is primarily responsible for setting the strategic focus of the Bank, while facilitating and implementing the language of responsible management by overseeing the business and related areas in particular ensuring:

BOARD SIZE

The Board size *(BS)* variable is described by the number of directors on the board at the end of each examined financial year. Research on the relation between performance and effectiveness of board of directors can be examined from three perspectives. These are board composition, insiders' ownership and board size. Papers that addressed the relation between board composition and performance (Hermalin and Weisbach, 1991; Klein, 1998; Bhagat and Black, 2000) reached the conclusion that there is insignificant relationship between accounting performance measures and percentage of outside directors on the board.

There are various arguments regarding board sizes. Jensen (1993) argues that "Keeping boards small can improve their performance. It is widely believed that companies with small board of directors are more effective and profitable since they have a better monitoring role (Jensen and Meckling (1976). Indeed, Jensen (1993) concludes that the effectiveness of a Board may decline as Board size increases above a moderate number. When boards get beyond seven or eight people they are less likely to function effectively and easier for CEO to control." Similarly Lipton and Lorsch (1992) states "when a board has more than ten members it becomes more difficult for them all to express their ideas and opinions." and add that the U.S. corporate boards are overcrowded which causes shareholders to lose money, employees to lose their jobs and the corporation to lose its competitive market position. Yermack (1996) examines the relationship between firm performance and Board size on a sample of large U.S. corporations and finds a significant negative relationship. The result is robust to numerous controls for firm size, industry membership, inside stock ownership, growth opportunities and alternative corporate governance structures. Lipton and Lorsch (1992) argue for smaller boards and recommend that board size should be limited to seven or eight members. The disadvantages of large boards lean on the idea that tasks like communication, coordination and decision making is much harder and costlier among large group of people than in smaller groups. Eisenberg et al (1998) conclude similarly for a sample of small and midsize Finnish firms.

There are also numerous studies that find a positive relationship between board size and firm performance. Bhagat and Black (2002) find that the negative relationship between board size and performance is not robust to the change of the performance measure. Adams and Mehran (2005) studied the relation between board size and firm performance by a sample of 35 publiclytraded US bank holding companies during 1959-1999. They concluded that board size does not have a negative effect on performance. Tanna, Pasiouras and Nnadi (2008) underscore the positive relation between board size and performance for English banks. Belkhir (2008) finds that increasing board sizes do not undermine the firm performance and there is a positive relationship between board size and firm

performance. Similar results are also reached by Dalton et al (1999), Kyereboah-Coleman and Biepke (2006), Larmou and Vafeas (2009). Haleblian and Finkelstein (1993) argues that the major advantage of large boards is the collective information that the board possesses about factors that affect the value of firms, such as product markets, technology, regulation, mergers and acquisitions. Zahra and Pearce (1989) argue that larger boards are tougher to manipulate compare to boards with fewer seats. Anderson et al (2004) argue that investors of firms with larger boards believe that the financial accounting structures of those firms are monitored better, enabling those firms to decrease the cost of borrowing.

Board size as a variable that can influence corporate governance practices and firm performance in this study. It is acknowledge that the board size and firm size are correlated (Dalton et al. 1999; Yarmack 1996) and board size is related to firm performance (Kiel and Nicholson 2003). From an agency perspective, larger companies require bigger boards to monitor and control the managements actions. As suggested by agency theorist (Jensen 1993), an optimal limit should be around eight directors and Lipton and Lorsch (1992) suggested the maximum size of the board should be ten members, as greater numbers will interfere with the group dynamics and hinder board performance. An alternative view is that it is not the size that is important, rather it is the number of outside directors (Dalton et al. 1999). Therefore in the academic literature, this variable is measured using total number of directors (Abdullah 2004).

Moreover, many studies have examined the effect Board composition may have on firm performance, obtaining mixed conclusions. Fama (1980) and Fama and Jensen (1983) argue that non-executive directors add value to firms by providing expert knowledge and monitoring services. Outside directors are supposed to be guardians of the shareholders' interests through monitoring, or, in some cases, substitutes for other types of monitoring mechanisms.

Researchers have studied the most appropriate absolute number of directors that should be present in a board to obtain better performance and has been regarded as one of the important corporate governance variable (Bonn et al., 2004; Dalton et al., 1999; Pearce, Zahra, 1992). Hermalin and Weisbach (1988) examine board composition and firm performance in a chief executive officer (CEO) turnover equation. The results indicate that when boards are dominated by outside directors, the CEO turnover is more sensitive to firm performance than it is in firms with insider-dominated boards. Zahra and Pearce (1989) find a positive relationship between the percentage of non-executive directors on the board of directors and firm performance.

On the other hand, Vance (1968) realises that boards dominated by insiders exemplify higher financial performance. Agrawal and Knoeber (1996) estimate a simultaneous system of firm performance, board composition and other control variables. They observe that outside representation on the Board is negatively related with firm performance. Yermack (1996) also finds a negative relationship between performance and the proportion of outside directors. Moreover, Bhagat and Black (2001) observe a negative correlation between board independence and various measures of firm performance.

According to Bonn et al., 2004, the effectiveness of the board of directors is depended upon the consensus that the board can achieve based on the level of expertise and knowledge. It has been argued by the scholars that neither too much nor too small, the members of the board derive better performance. Larger boards though can build up better environmental links find it difficult to coordinate . Lack of cohesiveness and coordination of larger boards is outweighed by the external links, more knowledge and expertise. Hence it is the opinion of most of the researchers that larger boards will gain better performance. In contrast, smaller boards can agree on a particular outcome and engage in genuine interactions than the larger boards . Fernando in 2007 has found a negative relationship between the firm performance and board size in larger companies in Sri Lanka. Despite the previous findings, it is still debatable whether the effectiveness can be achieved from a smaller board or a larger board, different conclusions were given by different researchers in various contexts. According to Fernando, 2007, the average number of board members in Sri Lankan companies is 7.56 per board. For the purpose of the present study, the number of members in the board (SIZE) was taken from the annual reports. And the following hypothesis was developed to be tested.

Hypothesis: Board size is negatively associated with firm performance.

FIRM PERFORMANCE

To achieve long-term sustained value, companies should raise their performance from year to year. There is no unique definition of firm performance (Pattanayak, 2008 cited in Pavithra 2009). However, Investordwords (2009) define performance as 'the results of activities of an organization or investments over a given period of time'. Most of researchers classified firm performance into accounting and market performance to assess the performance of the firms. The accounting performance measures take account to the current status of the firm as the result of past performance, such as, return on asset (ROA).

Hermalin and Weisbach (1991) do not observe any relationship between firm performance and the fraction of outside directors. Bhagat and Black (1999) conclude similarly. Adams and Mehran (2003) support the view that a lack of correlation between the Board size and performance is consistent with the theory; directors, as a result of regulatory requirements, do not emphasize in value maximization over the safety and of the institution.

RETURN ON ASSETS (ROA)

Return on assets shows the profitability of the company's assets in generating profits. It indicates the effectiveness of the companies assets in increasing shareholders economic interests (Haniffa and Hudaib 2006). It also shows the efficiency of management in using its asset to generate earnings. ROA is calculated as follows:

$$ROA = \frac{\text{Profit after tax}}{\text{Total assets}}$$

METHODOLOGY

SAMPLE

The concern of this study is to assess the impact of corporate governance characteristics on firm performance of listed banks financial institutions of Sri Lanka. These organizations are categorized by the Colombo Stock Exchange (CSE) as bank, finance and insurance under industry sector classification. 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.

This study considered corporate governance practices from 2008 to 2010. For this analysis cluster sampling method was used. Here all listed financial institutions (33 companies in Sri Lanka) are divided in to four clusters such as banking, financing, leasing and insurance industries. Then 10 companies from banking and 5 companies from financing, leasing and insurance industry was randomly selected as sample (25 companies out of 33companies) due to the difficulty in accessibility of data

DATA COLLECTION

Variables selected to represent the board size and the firm performance data could be collected from the annual reports. Therefore all the data was collected from the published annual reports.

RELIABILITY AND VALIDITY OF THE DATA

Secondary data for the study is drawn from financial statements (i.e., income statement and balance sheet) of the concerned companies as fairly accurate and reliable. Therefore, these data might be considered reliable for the study. Necessary checking and cross checking were done while scanning information and data from the secondary sources. Sample of this study extracted from listed companies in Sri Lanka. Also Sri Lankan Colombo Stock Exchange is functioning under the government rules and regulations and adopting the international and Sri Lankan Accounting Standards. All these efforts are made in order to generate validity data for the present study. Hence, researchers satisfy content validity.

DATA ANALYSIS

The data were analyzed with SPSS to obtain quantitative measures of descriptive statistics, Pearson's correlation and analysis of regression.

RESULTS AND DISCUSSION

TABLE 1: DESCRIPTIVE STATISTICS

	Mean	Maximum	Minimum	Std. Dev
Board Size	9	16	4	2.4632
Return on Total Assets	0.0205	1.1559	-0.3874	0.1566

Source: Survey data

The above table shows the number of directors in the board (BS) have a wide range from 4 to 16. The mean of the size of the board (BS) is 9, with a standard deviation of 2.4632. This is in par with many studies undertaken previously. Based on the study of Pavithra (2009) in Sri Lanka the number of directors in the board (BS) have a wide range from 4 to 15. The mean of the size of the board (BS) was 8.16, with a standard deviation of 2.The Cadbury Committee report (1992) also recommends the size of the board to be between 8 and 10 members. Kathuria and Dash (1999) in their study have found that the size of the board as 9.83. Mak and Li (2001) in their research on determinants of corporate ownership and board structure: evidence from Singapore found the mean of the board size to be 8.04 and the board size ranges from 4 to 14. Carter et *al* (2003) in their research on board diversity and firm value (sample is drawn from Fortune 1000) found a mean of 10.986 on number of directors with a standard deviation of 3.105. An empirical study on corporate governance and firm performance carried out in Russia by Judge et *al* (2003) got a 9.6 mean on size of the board with a standard deviation 4.2 while range being 5 to 17.
Mean value of the ROA (0.0205) indicated that 2.05 % of return had been earning by the companies on the value of total assets.

TABLE 2: REGRESSION ANALYSIS BETWEEN BOARD SIZE AND FIRM PERFORMANCE

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Model				
C	0.212	0.088	2.425	0.024
Board Size	-0.020	0.010	-2.090	0.048
R-squared	0.160	F-statistic		4.366
Adjusted R-squared	0.123	Prob(F-statistic)		0.048
S.E. of regression	0.111			

Source: Survey data

The results of the regression indicated that coefficient of board size was negatively related to profitability and significant α = 5% level. It implied that the increase of board size will significantly affect the ROTA of the firms. The adjusted R^2 also called as the coefficient of multiple determinations, is the percent of the variance in the dependent. It explained uniquely or jointly by the independent variables was 0.123. The F statistics was used to test the significance of R.The model represented by regression F value and significant (F = 4.366, p = 0.048). The results indicated that hypothesis was accepted and there was a negative relationship between board size and Return on Total Assets. From the results presented above, it can be concluded that, board size is negatively and significantly related to bank profitability. This is in line with the findings reported in the literature review for other industries (Eisenberg, Sundgren and Wells (1998), Yermack (1996).

CONCLUSION

The study set out to provide empirical evidence about the effects of board size on profitability for a panel made up of a sample of 25 listed financial institutions for the period 2008-2010. Analyzing previous studies indicated that there are mixed findings in different contextual frameworks. Furthermore, the theories that have been developed also reveal different opinions with respect to the structure of the boards. This paper adds to existing literature such as Fernando (2007) who found a strong negative relationship between the board size and corporate profitability.
So far, it was observed a negative relationship between profitability (measured through ROTA) and the board size, which was used as a measure of corporate governance practices. A primary contribution of this paper is to produce estimates of the effect of board size on performance that can be given a causal interpretation. Moreover, it was found that standard OLS results provide valid and precisely estimated small negative board size effects. Hence this study uniquely contribute to the existing knowledge regarding the importance of assessing board size with respect to nonfinancial performance rather than restricting to financial accounting measures of performance. It is highly recommended that future research should be focused on non-financial aspects of performance rather than restricting to financial accounting measures of performance. It is recommended for the corporate sector to measure performance in terms of non-financial aspects such as customer satisfaction, employee satisfaction, investor confidence, etc.,

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