

Corporate Governance and Financial Performance: The Case of Australia and Sri Lanka

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This study analyses the correlation between Board attributes and company performance in a sample of 100 Australian and 100 Sri Lankan firms. The analysed Board attributes include size; gender ratio; fraction of non-independent members; and experience. The level of economic development considered to have a potential confounding effect on the outcomes. The analysis of the data suggest that: Boards in Australia are much larger than Boards in Sri Lanka; Boards are male dominated in both nations; and while Board structure provides predictive insight into firm performance, only a few individual attributes are significant. Important finding of this research is that the larger Boards of Australia have a significantly stronger influence on firm performance than the relatively smaller Boards of Sri Lanka. Future research should extend the review of the effects of Board size on corporate performance.

Keywords: Board structure, Board size, Independent directors, and Firm performance

JEL Codes: G30, G34 and G38

1. Introduction

The Board of Directors is a key internal control mechanism directed (among other things) at aligning the interests of shareholders and managers and/or disciplining/ removing ineffective management (Barnhart, Marr and Rosenstein 1994; Park and Shin 2003). Rajagopalan and Zhang (1990), Dehaene, De Vuyst, and Ooghe (2001), Klapper and Love (2004), Abidin, Kamal, and Jusoff (2009), Krivogorsky (2006), and Rajagopalan and Zhang (2008) assert that effective corporate governance (CG) enhances company performance, guidelines, rules and practices and, as a result, boosts the achievement of their objectives (Aoki 2000; Aguilera and Jackson 2003). Dehaene et al. (2001) and Dalwai, Basiruddin, and Abdul Rasid (2015) describe the key role of the Board of Directors as accountability for improving the shareholder-manager relationship via CG. In the past two decades, CG has become an exciting topic; particularly after a variety of high-profile corporate debacles (e.g., Enron, Barings Bank, and WorldCom) which precipitated the introduction of USA Sarbanes-Oxley Act in 2002.

The Corporate Governance Committee (1997, pp.1) asserts that: "...directors are entitled to govern the company, and to supervise and monitor the company's management in order to

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promote effective management and ensure prudent accountability to the shareholders". Donaldson (1990) suggests that CG structures also include controls, executive incentives, and other schema for monitoring and bonding process of the Board of Directors.

Prior statistical evidence of CG and company performance is somewhat mixed, i.e. Aldamen, Duncan, Kelly, McNamara, and Nagel (2012) note that, in Australia, experience and financial expertise have a positive effect on performance in small firms but (in contrast) longer-serving audit-committee chairs in larger firms tend to have a negative impact on performance. Aldamen and Duncan (2012) found that small companies with better CG practices did not lower their cost of debt. This study expands extant work on the effect of the Board structure, manager specific attributes, on firm performance by providing a comparison of firms in a developed nation with firms in an emerging nation. As such, the main research question is '...what is the association between Board structure and financial performance within Australian and Sri Lankan listed companies?' While most of CG studies focus on developed countries (Daily, Dalton, and Cannella 2003; Rajagopalan and Zhang 2008), there is an increasing interest in CG in developing countries (Mak and Li 2001; Haniffa and Hudaib 2006; Kato and Long 2006). This study contrasts a few aspects of Australian CG mechanisms with those in Sri Lanka to highlight how CG differs between a developed and an emerging economy. The effects of Board structure, company-specific and manager-specific attributes on company performance are evaluated as a part of isolating and highlighting the effect of country-development level on CG. Small open economy, Australia, is a developed country and has strong trade and cultural links with the developing and emerging countries of Asia. Its well-regulated capital markets that successfully weathered the Global Financial Crises (GFC) and its corporate sector are seen as paragon of ethical standards. Sri Lanka has recently experienced rapid economic growth after emerging from decades of civil war. While Sri Lanka's recent economic reforms are potentiating the gains from peace, Sri Lanka is still an emerging country with gaps in its development and market regulations.

This paper evaluates whether the development level influences CG and the effect of CG (i.e. the effect of Board structure on company performance) via a comparative review of key attributes of the structure and operation of company Boards in Australia and Sri Lanka. In the rest of this paper: Section 2 presents literature and hypotheses; Section 3 describes the research methods; Section 4 presents findings and discussions; and Section 5 concludes the paper.

2. Literature Review and Hypotheses

Boards of Directors play a dominant governance role in organisations and (among other things) seek to ensure that the managerial goals align with those of shareholders and that ineffective management and/or processes do not proliferate (Baysinger and Butler 1985; Hillman and Dalziel 2003; Kang, Cheng and Gray 2007; Andres and Vallelado 2008; Chen 2014; Ertimur, Ferri and Stubben 2010). Accordingly, the agency theory relevant to this study focuses on how Board structure and firm performance affect company value. Agency costs look at the battle between stakeholders and company management. Agency costs arise when one party (the agent) has discretionary power to make decisions that affect the wealth of another (the principal). Agency Theory issues arise when a principal must rely on an agent to act on his/her behalf (Miller 2002; Terjesen, Sealy, and Singh 2009). Agency Theory see the Board as a key element of the decision-control system (Bathala and Rao 1995). Generally, Boards of Directors serve two vital roles for companies: monitoring management on behalf of shareholders and controlling resources. Agency theorists state that effective monitoring is a

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function of a Board's incentives (Hillman and Dalziel 2003). The monitoring function focuses on the responsibility of directors to monitor managers on behalf of shareholders (Hart 1995: Hillman and Dalziel 2003: Helland and Sykuta 2005). Thus, the Board of Directors is an overarching control that monitors and controls the actions of managers (Johnson, Daily, and Ellstrand 1996: Young, Ahlstrom, Bruton and Chan 2001: Hillman and Dalziel 2003). However, there is considerable debate in the literature as to the effectiveness and the desirability of that Differences in CG structures suggest two competitive views, where Boards:

- i) Maximise the administrative control of the firm through adopting structures that allow the Board to review and control management, resulting in higher performance due to the inside information and better understanding of the needs of the company than is possible with outside independent directors (Lara, Osma, Penalva 2007) and
- ii) Minimise agency costs via adopting structures that require ratification and monitoring of management behaviour by outside directors, thus reducing the gradient between shareholders and management interest (Goodstein, Gautam, and Boeker 1994).

The theoretical foundation of the Board's monitoring function is derived from agency theory, which describes the potential for conflicts of interest that arise from the separation of ownership and control in organisations (Felton and Hudnut 1995). The Board of Directors provides a means to optimise principal-agent issues, i.e. as principals, shareholders must trust that the firm managers will act on their behalf (as agents) and that the Board of Directors (after monitoring the outcomes) will act as needed (Mallin, 2004). Jensen and Meckling (1976) offered agency theory as an explanation as to how companies could exist, given the presumption that managers are self-interested and do not bear the full wealth effects of their decisions, mistakes, and risks. The popularity of agency theory in governance research is likely due to it's:

- i) Capacity to group the actors/participants within a large firm into shareholders and managers); and
- ii) Use of the Economic-person assumption to simplify decision processes to *actors/participants are self-interested and generally unwilling to sacrifice their own interests for those interests of others* (Daily et al. 2003).

This study contributes to the literature by reviewing the answerability of the Board to stakeholders of firms operating in different economic environments, via the adoption of good governance practices to improve management and firm performance. The literature review suggests that CG studies (with some exceptions) have mostly focused on developed countries and that there is still significant scope for studies of the situation in emerging markets. Further, only a few studies give a serious comparison of GC in developed vs. emerging countries. Drawing on the literature outlined above, the following alternative-hypotheses are proposed.

Hypothesis 1: There are significant differences in the Board structure governance between developed (Australia) and emerging (Sri Lanka) countries.

Hypothesis 2: Board Structure constructs are expected to have a positive influence on its financial performance.

3. Research Methods

This study uses quantitative techniques to assess the Board structure and company performance of Australian and Sri Lankan firms. The population of interest in the study is 200

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Australian Securities Exchange (ASX) listed companies (S&P/ASX200) and 289 Colombo Stock Exchange (CSE) listed companies due to the similarities on market capitalisation, liquidity and listing characteristics in both countries as at February 2013. A 100-firms sample, randomly drawn from each of the exchange-listed companies (Saunders et al. 2009), was analysed. Further, some analysis was done using published financial statements and other secondary-data sources. The quantitative data were analysed using SPSS (version 21.0) to produce descriptive statistics and regression analysis.

In the empirical analysis, the data for independent variables are collected for 2011, providing for a one-year lag to the 2012 performance data. Thus, 2012-full-year data are used for performance data of Australian and Sri Lankan companies. Return on assets (ROA) and return on equity (ROE) are measures of company performance. ROA is a measure of performance used in the CG literatures (Dehaene et al. 2001; Leung, Richardson, and Jaggi, 2014; Chen 2014). ROE is used in existing studies to measure company performance (Krivogorsky, 2006; Bachiller, Giorgino, and Paternostro 2014). In independent variables, Board size, female ratio (female directors to total directors), independence ratio (independent directors are outside directors who are not employed by the company), and directors' experience are used to measure Board structure.

Table 1: Variables used to study the Board Structure and Firm Performance

Board Structure		
Variables	Measures	Symbols
Board size	Number of directors	BOS
Female ratio	Female directors to total directors	FER
Non-Independence ratio	Non-Independent directors/total directors	INDE
Director experience	Percentage of the Board being directors for more than 10 years	DIE
Firm Performance		
Variables	Measures	Symbols
Return on Assets	Net Income after Taxation /Total Assets	ROA
Return on Equity	Net Income after Taxation/Equity Capital	ROE

The association between Board structure (e.g. Board size, female ratio, Directors' experience and Board committee independence) and company performance is tested in this study with:

$$ROA = a_0 + a_1 BOS + a_2 FER + a_3 INDE + a_4 DIE \quad (Eq 1)$$

$$ROE = b_0 + b_1 BOS + b_2 FER + b_3 INDE + b_4 DIE \quad (Eq 2)$$

Where:

a_0 and b_0 , = constant terms,

$a_1, a_2, a_3, a_4, b_1, b_2, b_3, b_4$, are regression coefficients, and Variables are listed in Table 1.

4. Findings and Discussion

4.1 Descriptive Statistics Analysis

Based on the questionnaire responses, the descriptive statistics of the attributes of Board structure in Australia and Sri Lanka were calculated and using SPSS v. 21 (software) and are summarised in Table 2.

Table 2: Descriptive Statistics: Australia and Sri Lanka

	Australia				Sri Lanka			
	Minimum	Maximum	Mean	SD	Minimum	Maximum	Mean	SD
BOS	6.00	35.00	15.390	4.297	3.00	13.00	8.050	2.231
FER	0.00	50.00	14.057	10.610	0.00	37.50	5.477	8.171
INDE	25.00	88.89	64.017	10.682	12.50	87.50	62.570	15.256
DIE	0.00	76.92	29.053	18.052	0.00	100.00	36.187	20.467

Board Size: Australia and Sri Lanka

The 100 companies in each of the two samples are drawn from a range of industrial sectors. Board size (BOS) for the Australian selected companies (in the descriptive statistics) in 2011, averaged 15 and ranged from six to 35 members. The Sri Lankan BOS, in 2011, averaged 8.05 and ranged from 3-13 members. This result is consistent with the extant literature. Bostock (1995) notes that average Board size in UK was 12-13 directors and Yermack (1996) assert that US Boards average 12 members. Hanson and Song (2000), note that number of Directors in USA Boards has declined over the years. Dehaene et al. (2001), notes that USA Board sizes had a maximum size of 35 members. The Olivencia report in Spain recommended an ideal size of Boards of 5 to 15 (Garcia Lara et al. 2007). From a resource availability perspective, bigger Boards should be relatively more effective. Specifically, Hillman, Cannella, and Paetzold (2000), Palmer and Barber (2001) report that the Board of Directors is a substantial resource for companies. Van den Berghe and Levrau (2004) argue that increasing the number of Board Directors provides an increased pool of expertise and thus larger Boards are likely to have more knowledge and skills at their disposal. Similarly, resource dependence theory suggests that larger Boards may have a better ability to form environmental links and secure critical resources (Goodstein et al. 1994). Conversely, overly large Boards can experience such issues as a lack of cohesion, coordination issues, and fractionalisation (Bonn, Yoshikawa, and Phan 2004). Kiel and Nicholson (2003) noted that Australian Boards are usually small (i.e. an average of fewer than 10 directors). In contrast, this study found that 96 percent of Australian companies have Boards with over 10 members and 81 percent of Sri Lankan firms have Boards with under 10 members.

Gender Diversity: Australia and Sri Lanka

In Table 2, there are few female directors in either country. Specifically, female Board members in Australian companies averaged 5 percent and ranged from 0-50 percent; and in Sri Lankan companies averaged 14 percent and ranged from 0m-38 percent. These results are consistent with the recent study by Kang et al. (2007) which also revealed that gender diversity in Australian Boards is very low in comparison to the USA (i.e. only 13 percent of Fortune 500 companies did not have a female director; Hyland and Marcellino 2002). Sheridan (2001) found few female directors in Australian-listed firms (i.e. few of the 857 firms examined, had female directors and 25 had predominantly male Boards). It is, however, slightly higher than the female representation reported in some European and Asian countries. The issue of

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gender in Board diversity is particularly apt given recent Europe efforts to increase female representation on Boards (Brennan and McCafferty, 1997; Singh, Vnnicombe and Johnson 2001). In the UK, the average female representation in Boards increased from 27.8-28.0 percent from 2001 to 2005 (Martin, Warren-Smith, Scott, and Roper 2008; Gregory-Smith, Main, and O'Reilly 2014). Although some progress is being made in appointing females to Boards of Canadian companies, only about five percent of Canadian directors are female (Burke 1994). Terjesen and Singh (2008) note that, on average, female representation on Boards are 13, 6, and 3 percent in, respectively, the USA, the UK, and Japan. Hyland and Marcellino (2002) found low gender representation on Boards in Japan, with three percent of Directors being female. The results reveal that 14 and five percent of all (Board) Directors are female in, respectively, Australia and Sri Lanka. Undoubtedly, there is still a gender imbalance in the higher-level governance positions both developed and emerging countries.

Board Independence: Australia and Sri Lanka

According to the CSE (2013) listing guidelines, independent Board members should not relate to a key employee, are independent from management, and have never worked at the firm or its subsidiaries, or for its consultants or major stakeholders.

Table 2, notes that most of the selected Australian firms have a majority (89 percent) of their Board being independent directors. Albeit, 25 percent of companies have minimum independent directors on board, with averagely 64 percent of directors are independent position in the Boards. The result of this study are consistent with Stapledon and Lawrence (1996) who find that Australian Boards have a majority of members who are independent. Whereas, results also show that 88 percent of the Sri Lankan companies' directors are independent directors. This proportion is similar to the Australian results. Especially, the number of independent directors ranged from 13-88 percent, which is above the minimum recommended by the ICASL code of best practice of 2003. Prior studies suggest that the number of independent directors on Boards of UK companies has increased considerably. Conyon (1994) examined the corporate governance changes in UK and the study consisted of 400 large UK companies in the Times 1,000 companies between 1988 and 1993. The results suggest that the mean percentage of independent directors increased from 38-44 percent from 1988 to 1993. However, Peel and O'Donnell (1995) report that UK Boards have an average of eight directors, of which three are independent (only eight percent of companies did not have independent directors). A majority (54 percent) complied with the Cadbury Committee's recommendation that all Boards should contain a minimum of three independent directors. In Belgium, the number and percentage of non-independent directors decreased over time, while the number and percentage of independent directors increased (Dehaene et al. 2001). Most corporate governance rules and codes globally require Boards of Directors of listed companies have identified groups of independent and non-independent directors (Jackling and Johl 2009). The ASX Corporate Governance Board notes that a majority of the Board should be independent directors. Similarly, the New York stock exchange (2003) requires all listed firms to have a majority of independent directors on their Boards. The UK Combined code of 2004 provides that at least half of the Board members be independent directors. The Malaysian code on corporate governance (2000) recommends that there needs to be balance on the Board of Directors with at least a third of the Board Directors should be independent directors. It is consistency with CG rules as required by section 7.10 of the listing rules of the Colombo Stock Exchange (CSE). In India, the Birla committee 2004 requires the Board of Directors of a company to have a mix with not less than half of the being independent. Monitoring is more effective with a larger percentage of independent directors because of better information sharing by directors (Raheja 2005; Lehn, Patro, and Zhao 2009; Chen 2014). Consequently,

this study concludes that Australia and Sri Lanka, independent directors have a larger influence on the Board similar to existing studies (Jackling and Johl 2009; Chen 2014).

Directors' Experience: Australia and Sri Lanka

Table 2 suggests that (on average) just over 29 percent of directors in Australian sample companies have over 10 years directors' experience and 77 percent of directors have over 10 years managerial experience. The results also show that around 36 percent of directors have over 10 year experience. Surprisingly, there appears to be a dearth of published research on directors' experience on developed or emerging countries.

4.2 Regression Analysis

Table 3 presents findings of regression analysis with information on the impact of an independent variable on the dependent variable. In Australia results, the model R² value of two performance ratios indicate that 5-23 percent of the observed variability in firm performance can be explained by the Board structure. The F-statistics and significance level (Table 3) shows that ROA model generate statistically significant outcomes in Australia. Whereas, of the Sri Lanka models R² value of the two performance ratios indicate that each three percent to the observed variability in company performance is explainable by the Board structure variables. The F-statistics and significance levels (Table 3) show that both ROA and ROE models generate statistically insignificant outcomes.

Table 3: Predictors of ROA and ROE – Model summary

	Australia		Sri Lanka	
	ROA	ROE	ROA	ROE
R	0.476	0.224	0.175	0.188
R ²	0.227	0.050	0.031	0.035
R ² Adjusted	0.194	0.010	0.010	0.005
F-Statistics	6.973	1.260	0.750	0.868
Significance level	0.000	0.291	0.560	0.486

Table 4 displays the results of the coefficient estimation for each performance measure studied. The impact of BOS on ROA in Australia is significant at the 1 percent level ($t=5.036$ and $p=0.000$). However, the other variables in that equation are not statistically significant. The impact of DIE on ROE is significant ($t=2.119$ and $p=0.037$) at the 5 percent level, all the other variables are not statistically significant though all have positive signs. While, none of the Sri Lankan variables is statistically significant, they all (as expected) have positive signs.

Table 4: Coefficients for predictors of ROA and ROE
(p values are given in parenthesis)

Models	Australia		Sri Lanka	
	ROA	ROE	ROA	ROE
Constant	3.322 (0.001)	0.171 (0.865)	1.749 (0.084)	1.418 (0.160)
BOS	5.036 (0.000)***	0.362 (0.718)	1.122 (0.265)	0.900 (0.371)
FER	0.506 (0.614)	0.005 (0.996)	0.305 (0.761)	0.617 (0.539)
INDE	1.277 (0.205)	0.495 (0.621)	0.065 (0.948)	0.217 (0.829)
DIE	0.623 (0.535)	2.119 (0.037)**	1.092 (0.278)	1.274 (0.206)

Significant at: *** = 1%; ** = 5%; * = 10%

5. Conclusion and Future Research

This study investigates whether: 1) Board attributes significantly different between Australian and Sri Lankan firms; and 2) Those attributes and/or differences influence firm efficiency. It was found that Australian firms have relatively large Boards (a mean of 15 with a range of 6-35) compared to Sri Lankan firms (a mean of eight with a range 3-13). The participation of females on Boards is low in both nations. Consistent with good-CG, independent directors make up the vast majority of Board members and that has a significant positive effect on ROA in Australia. However, the relationship in Sri Lanka is statistically insignificant. An important finding of this study is that Australian Boards tend to be significantly larger than Boards in Sri Lanka. As a result, Board size may be a confounding factor that entangles and prevents the influence of Board and company attributes from becoming apparent. These findings support the assertion that *there are significant differences in the Board structure governance between developed and emerging countries* (respectively, Australia and Sri Lanka). The results, also, affirm the assertion that *Board structure constructs are expected to have a positive influence on a company's financial performance*.

A key limitation in this study flows from the difficulties inherent in discovering and adjusting for variations in the GC mechanisms, business scope, and/or financing portfolio across companies. Like most previous studies, this study examined only selected proxies for company performance. Difficulties arising from accounting standards and principles differing between countries were greatly mitigated over the past decade by the spread of International Financial Reporting Standards (IFRS).

Future research should consider including many countries. The effect of Board size on company performance should be more fully examined in future research. Such research might best be a study "jointly and severally" across a range of developed and emerging nations. In addition, future research might expand its consideration to include the influence of socio-economic factors and human capital on corporate governance.

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