IMPACT OF BOARD DEMOCRACY ON FINANCIAL PERFORMANCE OF FIRMS LISTED IN COLOMBO STOCK EXCHANGE

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Abstract

Along with the widespread attention on corporate governance due to a series of corporate failures directly attributable to agency issues, many countries have formulated best practices and have incorporated these into listing rules of capital markets. These best practices essentially aim to instil democracy in the governing structure of corporations. Nevertheless, neither the level of compliance nor the effectiveness of the best practices in enhancing performance is known without doubt. Therefore, this study first measures the compliance with the best practices using a corporate governance index which is used in this study as a proxy for board democracy and then investigates its effect on firm performance measured using ROA and Tobin's Q. Data was collected on a random sample of 100 firms listed in the Colombo Stock Exchange in Sri Lanka for 2014 and 2018. Findings showed an increase in board democracy as indicated in higher compliance with corporate governance best practices in 2018 compared to 2014. However, even though higher compliance with corporate governance best practices is associated with higher financial performance, its influence on market performance was not evidenced. Therefore, though the effect of board democracy on firm performance cannot be entirely denied, further studies are required to investigate whether the prevailing best practices enhance board democracy so that it can influence firm performance.

Keywords: agency theory, board democracy, corporate governance, financial performance, stewardship theory

1. Introduction

Increasing complexity has led to the separation of control of the businesses from their ownership, creating a potential conflict of interest between shareholders and managers, as explained in the agency theory (Jensen & Meckling, 1976). Nevertheless, initial arguments on conflict of interest between owners and managers can be traced back to the seminal works by Adam Smith in 1776 (Hermalin & Weisbach, 2003). When appropriate incentives and screening and monitoring mechanisms are absent, the managers can misappropriate corporate resources for their benefit. Here, corporate governance establishes a mechanism to minimise opportunistic managerial behaviour and thereby minimise agency costs by specifying the rights and responsibilities of different stakeholders while streamlining the decision-making process by setting up internal controls and procedures (Azeez, 2015; Manawaduge, 2012). As a result, an increase in firm performance or, as argued in the stakeholder theory, from a broader perspective, an increased alignment of stakeholder expectations is generally expected.

In fact, the mainstream corporate governance mechanisms aim to balance the executive power within the board through decentralising, ensuring equal rights, and increasing the board's representation with respect to all stakeholders (Gomez & Korine, 2005). Ray (2005) also claims that effective corporate governance practices are the ones that enhance democracy and representation. Therefore, this paper calls it the board democracy mainly to give it a more political and social context. This concept, in a way, closely resembles the governance structure in a country characterised by a democracy where mechanisms for the separation of powers and representation are in place, as argued in Persson, Roland, and Tabellini (1997). In this context, the best practices of corporate governance can be seen as procedures of democracy ensuring the fairness of corporate decisions. In a democratic board, no one party has undue power in influencing the decisions. The prevailing corporate governance recommendations, for example, on the board size, CEO duality, the proportion of non-executive and independent directors, and the presence of various independent committees such as a nomination, remuneration, and audit committees collectively instil a democratic environment for making value-maximising decisions. Therefore, this paper assumes that board democracy increases with higher compliance with prevailing corporate governance best practices.

By design, the best practices of corporate governance based on agency theory seem to be more suited for contexts

characterised by low trust, conflict of interests, and high transaction costs. In contrast, the practices based on stewardship theory rely more on trust-based cultural contexts with stronger institutions where individual managers naturally act in the shareholders' best interest. Stewardship theory prescriptions may also be relevant where owners themselves engage in management. As Jensen and Meckling (1976) argued, conflicts of interest arise with the decrease of the owner-managers claims. In other words, when minority shareholders who do not involve in the management are present, large shareholding managers may exercise their executive power in consuming the firm's economic resources at the expense of the minority shareholders (Anderson & Reeb, 2004). This phenomenon is commonly known as principal-principal agency problems.

Some of the recent failures of large corporations like Enron and WorldCom, together with the US subprime mortgage crisis, have brought corporate governance into the limelight of policymakers and researchers (Brown & Caylor, 2006). Even in Sri Lanka, cases like Pramuka Bank, Golden Key Credit Card and SR Property Sharing Investment, among others, called the attention of researchers and policymakers to addresses the issues of agency conflicts (Azeez, 2015). Even though the initial efforts toward corporate governance in Sri Lanka dates back to the British colonial period, the first formal Code on Corporate Governance in Sri Lanka was introduced by the Institute of Chartered Accountants of Sri Lanka as a voluntary code of best practices in 1997 based on the code of best practices of the UK introduced in 1992. Subsequently, this code was amended in 2003, 2008, 2013 and 2017 in consultation with various stakeholders. Though the disclosure of some of the best practices on corporate governance was made a mandatory listing rule in CSE since 2008 (Colombo Stock Exchange, 2021), compliance with the best practices of non-listed firms is essentially a management discretion. Therefore, even the listed firms still have sufficient room for non-compliance.

Theoretically, corporate governance shall have a positive effect on firm performance. Nevertheless, empirical evidence is mixed with respect to different practices adapted for ensuring corporate governance and the association between corporate governance and firm performance (Dalton, Daily, Ellstrand, & Johnson, 1998). For example, some literature suggests that better corporate governance generally enhances firm performance (Brown & Caylor, 2006; Gompers, Ishii, & Metrick, 2003). However, as shown in Table 1, many

studies show that only some corporate governance practices are associated with higher firm performance (Arora & Sharma, 2016; Azeez, 2015; Bebchuk, Cohen, & Ferrell, 2004; Brown & Caylor, 2006; Mashayekhi & Bazaz, 2008; Vo & Phan, 2013).

Further, many listed firms in Sri Lanka are characterised by family ownership, concentrated ownership, and controlling shareholders engaged in the management (Hewa Wellalage & Locke, 2014; Manawaduge, 2012; Wijethilake, Ekanayake, & Perera, 2015). Weak institutional framework, financially shallow equity market and presence of many firms with founding family ownership can be identified as the key reasons behind this type of concentrated ownership in developing countries like Sri Lanka (Hewa Wellalage & Locke, 2014). These contextual settings make Sri Lanka a compelling case of corporate governance. Nevertheless, recent literature on this topic relating to Sri Lanka is scarce.

Given the above discussion, the research problem in this study is threefold. First, the literature highlights that the conditions under which the conventional corporate governance guidelines would yield optimal outcomes are yet unknown (Hermalin & Weisbach, 2003). Second, the nature and effectiveness of various corporate governance practices in alleviating agency conflicts depend primarily on each country's institutional and cultural backgrounds. As a result, the applicability of the claims made in the literature relating to a particular context is less applicable in other contexts. In this sense, a central issue here is to define what constitutes good corporate governance in each context. Finally, the applicability of market-based corporate governance practices with Anglo-Saxon origin aimed at firms with diffused ownership in the Sri Lankan context characterised by concentrated ownership is still debatable.

Therefore, this study makes three attempts. First, to measure board democracy using an index by taking the level of compliance of listed firms in Sri Lanka with the corporate governance best practices as a proxy. Second, to examine whether the compliance has been increased recently. Finally, to assess whether such compliance is associated with financial performance measured using ROA and Tobin's Q.

2. Literature Review

Corporate governance acts as a mechanism in enhancing investor confidence, attracting investment and thereby improving firm performance. In this setting, the board of directors is an endogenously emerged institutional arrangement to respond to inherent

agency conflicts in modern firms (Hermalin & Weisbach, 2003). Here, the board of directors act as the focal point in setting the firm's strategic direction, source of expertise and advice, and the ultimate mechanism for monitoring and disciplining the firm's management (Adam, Hermalin, & Weisbach, 2010).

As Jensen and Meckling (1976) argued, a firm can be viewed as a nexus of contracting relationships. These contracting relationships balance conflicting objectives of individuals or groups. Here, t he contractual relationships between the shareholders and the managers are critical since the ownership is separated from the management in modern firms. Moreover, given that managers have better access to information and expertise, they gain an advantageous position relative to owners (Dalton et al., 1998). This position allows managers to pursue self-interested actions leading to a conflict of interest (Adam et al., 2010; Davis, Schoorman, & Donaldson, 1997; Jensen & Meckling, 1976).

Mainly when the monitoring mechanisms are poor or appropriate incentives are missing, the managers may misuse the owners' wealth for their benefits. This misbehaviour may be in the form of revealing insider information for their benefit or wasting corporate resources by rewarding themselves with excessive remunerations or engaging in value reducing transactions with related parties (Anderson & Reeb, 2004; Ntim & Oseib, 2011; Shleifer & Vishny, 1997). In other words, as argued by Jensen and Meckling (1976), this gives rise to a set of agency costs. Managing these opportunistic behaviours requires costly monitoring (Jensen & Meckling, 1976). By incurring monitoring costs, the principals try to make sure that all the decisions taken by the agents are in the best interest of the principals.

When managers do not have any claim on the residual benefit or when the managers' claim on the residual benefit is reduced, conflicts of interest arise in various forms (Jensen & Meckling, 1976). Consequently, not only can the profitability decline (Brown & Caylor, 2009), but the firm's market value can fall since the equity markets anticipate an increase in agency costs (Gompers et al., 2003). Therefore, corporate governance can enhance firm performance by acting as a mechanism that reduces agency costs. As argued in the literature, the best practices of corporate governance advocated in many countries seem to stem from the arguments in the agency theory, which claims that democratic boards characterised with participative leadership and stronger shareholder rights enhance firm value (Gompers et al., 2003).

Similar to the procedures of democracy in a country, the corporate governance procedures aim to promote enfranchisement, separation of powers and representation (Gomez & Korine, 2005). In this sense, the best practices of corporate governance can be seen as procedures of democracy ensuring the fairness of corporate decisions (Ray, 2005). Nevertheless, most prescribed practices seem to emanate from the US (Bhagat & Black, 2001). More precisely, the conventional corporate governance prescriptions are based on the presumptions that the ownership of modern organisations is diffused, the free-rider problem is prevalent, and the information asymmetry between the owners and managers is profound (Hermalin & Weisbach, 2003).

Among the prevailing corporate governance best practices, the board size, CEO duality, the proportion of non-executive and independent directors, presence of various independent committees like a nomination committee, a remuneration committee, an audit committee have attracted widespread attention in the literature. These mechanisms essentially aim to balance the executive power within the board by decentralising, ensuring equal rights, and increasing the board's representation with respect to all shareholders (Gomez & Korine, 2005).

Along with the claims made in the agency theory, ample literature supports that CEO duality is associated with CEOs having substantial decision-making power (Adam et al., 2010). This arrangement eventually reduces the balance of power in the board and removes an important check on the CEO discretion, leaving more opportunities for the CEO to pursue his interests (Dahya, Lonie, & Power, 1996). Moreover, CEO duality can deteriorate the independence and effectiveness of the board subcommittees (Kamarudin, Wan Ismail, & Samsuddin, 2012). Since the separation of these two roles separates the decision management from decision control, a more democratic environment emerges for participative decision-making where CEO's self-interested actions will be minimised (Fama & Jensen, 1983). Moreover, an independent chairperson can bring an outside perspective enriched with his personal experiences in other firms (Dahya et al., 1996). Finally, some empirical evidence supports the positive association between the absence of duality and firm performance (Rechner & Dalton, 1991; Wijethilake & Ekanayake, 2019).

The board effectiveness can be further strengthened by increasing the number of non-executive directors and independent directors in line with the claims in agency

theory (Dalton et al., 1998). These outside directors are supposed to monitor the board's actions (Hermalin & Weisbach, 2003). Thereby, they can better protect the interests of the external-minority shareholders (Anderson & Reeb, 2004), control managerial perquisites (Lu, Wei, & Li, 2010), constrain insider dealing (Bhagat & Black, 2001) and minimise financial reporting frauds (Beasley, 1996). This mechanism is particularly effective in firms characterised by concentrated or family ownership (Anderson & Reeb, 2004). Moreover, non-executive and independent directors with the required calibre on the board can be viewed as a source of expertise and independent advice. Numerous empirical studies support the positive association between the presence of outside directors on the board and the firm performance (Pearce & Zahra, 1992).

In contrast, the proponents of stewardship theory argue that there are situations where the managers are not necessarily individualistic or opportunistic so that the interests of managers and owners converge (Davis et al., 1997). More precisely, the managers being the stewards of the company, maximise the firm performance since they are inspired or intrinsically motivated to perform well in the best interest of shareholders. This intention can be mainly seen in firms with family ownership, where founding family members tend to take the firm's well-being equally with that of their own (Gomez-Mejia, Larraza-Kintana, & Makri, 2003). In this sense, the fundamental difference between the agency theory and stewardship theory is how the two theories conceptualise the individual's intentions and behaviours. For example, the individuals in agency theory are characterised with self-serving behaviours, while those in stewardship theory are characterised with pro-organisational behaviours. Therefore, as Oosterhout (2007) argued, democratic corporate governance may not be effective in publicly owned firms.

Corporate governance mechanisms prevailing in the Asia Pacific region have been primarily characterised by relationship- based mechanisms stemming from the stewardship theory. Here, the emphasis is placed on the mutual trust resulting from stronger ties and long-term relationships prevailing in a collectivist culture. Therefore, such corporate governance mechanisms aim to establish empowering governance structures characterised by relationship-based mechanisms that facilitate effective management (Davis et al., 1997). Here, unnecessary and rigid controls enforced on the management may hinder their reorganisational behaviours leading to poor performance.

Japanese *Keiretsu*, characterised by business groups and the main bank system, and Korean *Chaebol*, characterised by family ownership and stronger links with the government, are compelling examples of this relationship-based model of corporate governance.

Literature supporting the stewardship theory claims that clarity of command, the strength of leadership and efficiency of implementing operational strategies can be enhanced through combining the roles of chairman and CEO (Dahya et al., 1996; Donaldson & Davis, 1991). This is because the separation of these titles may give rise to additional agency costs (Hermalin & Weisbach, 2003), such as inconsistent decision making and information and monitoring costs for controlling the chairman (Brickley, Coles, & Jarrell, 1997). For example, Adam et al. (2010) show that imposing rules mandating the separation of the titles of CEO and chairman may result in inefficient or suboptimal outcomes. Therefore, CEO duality can enhance firm performance (Donaldson & Davis, 1991). Wijethilake and Ekanayake (2019) provide empirical support for this by claiming that CEO duality can enhance firm performance when the board involvement is high.

Concurrently, excessively larger boards may also turn ineffective (Eisenberg, Sundgren, & Wells, 1998; Hermalin & Weisbach, 2003; Yermack, 1996) due to increased communication and collaboration issues leading to reduced clarity in command and leadership. Moreover, non-executive directors without expertise in a particular business can also constrain firm performance. Therefore, some studies have highlighted the potential benefits of having inside directors due mainly to the degree and quality of information they have access to (Baysinger & Hoskisson, 1990).

In summary, as illustrated in Table 1, the literature provides little consistency, if any, on the relationship between corporate governance best practices and firm performance. For example, while some researchers have confirmed the positive effect of some aspects of corporate governance on firm performance (Brickley et al., 1997; Eluyela et al., 2018), some other studies provide evidence for a negative association (Guo & Kumara, 2012; Vafeas, 1999). Further, some studies have failed to observe any association between corporate governance and firm performance (Fuzi, Halim, & Julizaerma, 2016). These differences are partly attributable to how corporate governance is conceptualised and measured in each study.

Table 1: Effect of Popular Corporate Governance Indicators on Performance

Study	CGI	CEOD	BSize	MF	BI	IS
Akbar et al. (2016)	U					
Al-ahdal et al. (2020)	I					
Arora and Sharma (2016)		U	P	P	N	P
Bhagat and Black (2001)					N	
Bhagat and Bolton (2008)		N			N	
Bhatt and Bhatt (2017)	P					
Boyd (1995)		I				
Brickley et al. (1997)		P				
Brown and Caylor (2006)	P				U	
Dahya, Lonie, and Power (1996)		N				
Dalton, Daily, Ellstrand, and Johnson (1998)		U				
Eisenberg, Sundgren, and Wells (1998)			N			
El-Faitouri (2014)		U	U		U	
Eluyela et al. (2018)			U	P		
Fuzi, Halim, and Julizaerma (2016)					I	
Giroud and Mueller (2011)	P					
Malik and Makhdoom (2016)			N	N	P	
Mashayekhi and Bazaz (2008)		U	N		P	N
Shao (2019)		N	U			
Shaukat and Trojanowski (2017)	P					
Vo and Phan (2013)		P	N		U	
Wijethilake, Ekanayake, and Perera (2015)		P	N	P		

Notes: *CGI* stands for Corporate Governance Index, *CEOD* stands for CEO Duality, *BSize* stands for board size, *MF* stands for Meeting Frequency, *BI* denotes board independence, *IS* denotes institutional shareholding. *I* stands for Inconclusive, *N* stands for Negative, *P* stands for Positive, *U* stands for unrelated.

Concurrently, the literature provides ample evidence to claim that the applicability and relevance of management theories are highly dependent on cultural and other contextual settings (Boyd, 1995; Davis et al., 1997; Hewa Wellalage & Locke, 2014; Holm & Schøler, 2010). In this sense, agency theory may be more applicable in developed markets where robust institutional frameworks are present. In contrast, the prescriptions made in stewardship theory may fit more with contexts characterised by concentrated ownership and more emphasis on relationship-based informal

institutions. Moreover, the optimal composition of the board and hence what constitutes best practices of corporate governance may largely depend on the market conditions and, the phase of the business cycle (Dahya et al., 1996) and the firm's stage in its life cycle. This phenomenon highlights the necessity of more empirical studies to investigate the effectiveness of different corporate governance best practices under different contexts.

3. Methods

This study examines the effect of board democracy, proxied by corporate governance compliance, on firm performance based on the data collected on 100 firms out of 309 firms listed in CSE as of 11th November 2019 using a multi-stage sampling technique. Even though banks and financial institutions were not considered for sampling given the unique nature of rules and regulatory requirements on these firms and the mandatory nature of the code of best practices on corporate governance (Azeez, 2015; Mapitiya, Ajward, & Seneratne, 2015), steps were taken to ensure that the sample consists of firms with varying sizes. Then the effect of size was controlled using a control variable. The data was collected through published annual reports for 2014 and 2018.

Previous studies like Manawaduge (2012) have used corporate governance index calculated using survey-based primary data to quantify the level of compliance with corporate governance best practices. However, since the prevailing corporate governance practices in Sri Lanka rely heavily on the market-based and disclosure- oriented framework, this paper intends to use a Corporate Governance Index (CGI) calculated based on the data available on the published annual reports. This index captures a firm's compliance with 18 equally weighted board-related best practices identified in the Sri Lanka Code of Best Practice on Corporate Governance–2017, as illustrated in Table 2. A value of one was assigned if a firm has complied with a particular best practice, and a value of zero was assigned otherwise. Then, the CGI is calculated by summing the scores obtained for all 18 best practices. Therefore, the CGI can range from zero to 18. This index draws on the approaches of Akbar et al. (2016), Bhatt and Bhatt (2017), Brown and Caylor (2006), Gompers et al. (2003) and Shaukat and Trojanowski (2017). Nevertheless, the construction of an index with varying weights, instead of using equal weights for all factors, has been encouraged in some studies (Bebchuk et al., 2004; Brown & Caylor, 2006).

Generally, accounting-based measures of firm performance reflect a short-term perspective, while market-based

measures reflect a long-term perspective (Al-Matari, Al-Swidi, & Fadzil, 2014). Therefore, reflecting both perspectives, this study used accounting-based ROA and market-based Tobin's Q similar to Eluyela et al. (2018) to measure firm performance.

A paired-samples t-test was used to examine whether the level of compliance is different in 2018 relative to 2014. Moreover, based on the agency theoretic literature, this study hypothesises that board democracy proxied by compliance with corporate governance best practices enhances firm performance. To test this hypothesis, two OLS regression models, as specified in equation 1, was used to assess the effect of level of compliance on the firm performance where firm performance denoted by FP was replaced with ROA and Tobin's Q in the two models. Here, firm size measured in terms of the natural logarithm of total assets, leverage measured in terms of debt ratio and firm age measured in years since the initial listing was also included in the model to control diversity in the selected sample. Similar regression models have been used by Azeez (2015) and Mashayekhi and Bazaz (2008). Nevertheless, they have used individual components of corporate governance as predictors in contrast to the corporate governance index used in this study.

$$FP_i = \alpha + \beta_1 CGI_i + \beta_2 LEV_i + \beta_3 FSIZE_i + \beta_4 AGE_i + \varepsilon \text{ ------------------- (1)}$$

Here, α, β, and ε denote intercept, coefficients and random error, respectively. CGI denotes corporate governance index; LEV, FSIZE and AGE respectively stand for leverage, firm size, and firm age. Table 2 illustrates the operationalisation of the variables in detail.

4. Findings and Discussion

This study primarily examined whether the board democracy as reflected in the level of compliance with 18 corporate governance best practices has been increased recently to assess whether such compliance is associated with financial performance measured using ROA and Tobin's Q.

The results of paired samples t-test indicated that the level of compliance in 2018 ($M = 0.76$, $SD = 0.14$) is higher than that of 2014 ($M = 0.69$, $SD = 0.15$) implying that the level of corporate governance compliance has been increased over time ($t(98) = -5.84$, $p < 0.001$). This increase could indicate that various initiatives taken to make the code of best practices popular among the firms have paid off to some extent. Therefore, this can be interpreted as an increase in board democracy provided the agency theoretic claims supporting the prevailing best practices are valid.

Table 2: Operationalisation of the variables

Variable	Operationalisation
Firm Performance (FP)	
ROA	Return as a percentage of total assets
Tobin's Q	The market value of equity and debt divided by the book value of equity and debt
Corporate Governance Index (CGI)	
CEO duality (one indicator)	1 if the responsibility is divided between CEO and Chairman, 0 otherwise.
Board independence (two indicators)	1 if at least 33% of the board are non-executive directors (if CEO and chairman are the same person majority should be NED), 0 otherwise.
	1 if at least 66% of the non-executive directors in the board are independent non-executive directors, 0 otherwise.
Board meetings (one indicator)	1 if the board has met at least once in every quarter, 0 otherwise.
Remuneration Committee (five indicators)	1 if there is a remuneration committee, 0 otherwise.
	1 if an independent non-executive director chairs the remuneration committee, 0 otherwise.
	1 if the remuneration committee comprised entirely of NEDs, 0 otherwise.
	1 if there are at least three non-executive directors in the remuneration committee, 0 otherwise.
	1 if the majority of the remuneration committee is independent non-executive directors, 0 otherwise.
Audit committee (five indicators)	1 if there is an audit committee, 0 otherwise.
	1 if an independent non-executive director chairs the audit committee, 0 otherwise.
	1 if the audit committee comprised entirely of non-executive directors, 0 otherwise.
	1 if there are at least three non-executive directors in the audit committee, 0 otherwise.
	1 if the majority of the audit committee consists of independent non-executive directors, 0 otherwise.
Nomination committee (four indicators)	1 if there is a nomination committee, 0 otherwise.
	1 if an independent non-executive director chairs the nomination committee, 0 otherwise.
	1 if the majority of the nomination committee consists of non-executive directors, 0 otherwise.
	1 if the nomination committee consists of at least 33% of independent non-executive directors, 0 otherwise.

Leverage (LEV)	Debt as a percentage of total assets
Firm size (FSIZE)	Natural logarithm of total assets
Age (AGE)	Years since the initial listing

Table 3: Descriptive Statistics

Year	**Variable**	**Symbol**	***n***	**Min.**	**Max.**	**Mean**	***SD***
2014	Corporate Governance Index	CGI	99	0.11	1.00	0.69	0.15
	Return on Assets	ROA	93	-0.05	0.18	0.05	0.05
	Tobin's Q	TQ	95	0.06	2.62	1.31	0.58
	Leverage	LEV	99	0.00	0.87	0.32	0.22
	Firm size	FSIZE	98	18.20	25.46	21.73	1.43
	Age	AGE	98	0.00	65.00	25.20	16.57
2018	Corporate Governance Index	CGI	100	0.44	1.00	0.76	0.14
	Return on Assets	ROA	97	-0.16	0.17	0.04	0.06
	Tobin's Q	TQ	86	0.20	1.45	0.83	0.28
	Leverage	LEV	100	0.01	1.42	0.41	0.26
	Firm size	FSIZE	100	18.25	26.50	22.47	1.61
	Age	AGE	100	1.00	69.00	28.97	16.65

Table 4: Regression Results

Variable	**Symbol**	***β***	***t***	***VIF***
Model A (ROA): $R^2 = 0.239, F (4, 92) = 7.216 (p < 0.001)$.				
Constant	α	-0.054	-0.715	
Corporate Governance Index	CGI	0.100**	2.431	1.139
Leverage	LEV	-0.091***	-4.114	1.106
Firm Size	FSIZE	0.002	0.585	1.152
Firm Age	AGE	0.000	0.845	1.095
Model B (Tobin's Q): $R^2 = 0.411, F (4, 81) = 14.104 (p < 0.001)$.				
Constant	α	1.364***	4.175	
Corporate Governance Index	CGI	-0.012	-0.069	1.147
Leverage	LEV	0.671***	6.937	1.133
Firm Size	FSIZE	-0.037**	-2.383	1.152
Firm Age	AGE	0.001	0.487	1.128

*Notes: ** and *** respectively indicates significance at 5% and 1% level.*

Table 3 shows the summary statistics of the variables used for regression analysis. ROA was used as the measure of firm performance in the first model. Kolmogorov-Smirnov test shows that the residuals of the first regression model are normally distributed (D (97) = 0.06, p = 0.200). VIF values and Durbin and Watson statistic indicates the absence of multicollinearity and independence issues. The overall regression model was statistically significant in predicting ROA, ($R^2 = 0.239$, F (4, 92) = 7.216, $p <$ 0.001, $DW = 2.218$).

As illustrated in Table 4, according to the first regression model, the level of corporate governance compliance measured using CGI positively affects ROA (â = 0.100, $p = 0.017$). This positive effect implies that corporate governance compliance improves internal monitoring and reduces agency costs, hence ultimately increase the efficiency of resource utilisation and firm performance (Haniffa & Hudaib, 2006; Jensen & Meckling, 1976; Kesner & Johnson, 1990) as argued in agency theory as well. These results are consistent with the previous literature, for example, Bhagat and Bolton (2008) and Giroud and Mueller (2011).

Further, consistent with most of the previous literature, like Sheikh and Wang (2013), a negative effect of leverage on ROA (ß = -0.091, $p < 0.001$) was observed in this study. This negative effect could be due to the increased cost of capital because investors tend to require a higher return to compensate for the higher risk of excessive debt financing (Stretcher & Johnson, 2011). Nevertheless, firm size (ß = 0.002, p = 0.560) did not have statistically significant effect on ROA.

In the second model, Tobin's Q was used as the measure of firm performance. The data in this model meets the assumption of independence (DW = 2.225). Kolmogorov-Smirnov test results indicated that residuals of this regression model are not normally distributed (D (86) = 0.144, $p < 0.001$). However, regression analysis was performed, ignoring this issue. Nevertheless, VIF values indicate the absence of multicollinearity issues in the model.

As illustrated in Table 4, the second regression model was also statistically significant in predicting Tobin's Q, (R^2 = 0.411, F (4, 81) = 14.104, $p < 0.001$). However, a significant effect of CGI on Tobin's Q could not be observed (ß = -0.012, p = 0.945). This finding is consistent with the findings of El-Faitouri (2014) and Gupta, Kennedy, and Weaver (2009), who have found no relationship between corporate governance compliance and Tobin's Q. This lack of relationship may be due to family

owners' dominance in the boards compared to other investors.

In contrast to the first model, the leverage positively affects Tobin's Q (ß = 0.671, $p < 0.001$). These results are consistent with the results of Berger and Patti (2006). Firm size shows a negative impact (ß = -0.037, $p = 0.019$) on Tobin's Q. In both models, firm age did not have a statistically significant effect on firm performance.

5. Conclusions

Findings suggest that increased board democracy reflected in higher corporate governance compliance is associated with better performance in terms of profitability, as argued in agency theory, mainly because corporate governance acts as a mechanism to reduce agency costs and improve financial performance. These findings are consistent with Bhatt and Bhatt (2017). Hence firms can improve their financial performance by increasing adherence to corporate governance practices regardless of the voluntary nature and cost associated.

Contrary to most of the prior literature, such as Al-ahdal, Alsamhi, Tabash, and Farhan (2020), this study's findings do not show any effect of corporate governance on market performance similar to El-Faitouri (2014). The inefficiencies in the Sri Lankan share market can explain this situation. In inefficient markets, the share prices are manipulated deliberately by giant investors, or mispricing can frequently occur due to family ownerships and the limited number of listed firms available for share trading in Sri Lanka. Investors also may be less concerned about corporate governance compliance.

Further, despite the voluntary nature of the corporate governance codes, firms are willing to comply with corporate governance practices. This is indicated by the higher compliance in 2018 relative to 2014. However, since firms comply with corporate governance practices at their discretion, there are vast differences in compliance.

Along with the empirical support available in this study as well as in the literature for both agency theory and stewardship theory, on the one hand, the best approach would be to investigate the conditions under which each theory fits better in designing appropriate corporate governance mechanisms to instil board democracy. On the other hand, efforts can be taken to blend the prescriptions made in both theories while paying due attention to the contextual and cultural elements embedded in the economy in developing governance mechanisms.

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