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**CORPORATE GOVERNANCE PRACTICES AND ITS EFFECT ON  
FIRM'S PERFORMANCE; A STUDY OF LISTED COMPANIES IN SRI  
LANKA**

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**A B S T R A C T**

The significance of corporate governance as a mechanism for ensuring accountability, transparency, and organizational effectiveness has been widely discussed in both financial and management literature. However, the empirical evidence regarding its influence on firm performance remains inconclusive, particularly in emerging market contexts characterized by concentrated ownership and evolving regulatory frameworks (Aguilera & Cuervo-Cazurra, 2009; Clarke, 2007). This study examines whether selected governance structures — board size, board independence, CEO duality, and the presence of board committees — are associated with financial performance among 100 non-financial companies listed on the Colombo Stock Exchange (CSE) over the period 2015–2019. Accounting-based performance indicators, namely Return on Assets (ROA) and Return on Equity (ROE), are used to assess firm performance. Secondary data sourced from audited annual reports and regulatory filings were analyzed using descriptive statistics, Spearman's correlation, and multiple regression analysis. The results indicate that while governance practices are broadly implemented, none of the selected governance variables exhibits a statistically significant impact on firm performance. Board independence shows a positive but weak association with profitability, whereas CEO duality and board size demonstrate negligible effects. These findings imply that formal governance mechanisms in Sri Lanka may function more as compliance tools

than as drivers of enhanced profitability. The study contributes to the sparse empirical evidence on corporate governance effectiveness in emerging markets and suggests directions for further research, including the consideration of ownership structure and market valuation metrics.

**KEYWORDS:** Corporate governance, board structure, firm performance, Colombo Stock Exchange, emerging markets, agency theory.

## 1. INTRODUCTION

### 1.1 Background and Justification

Corporate governance is broadly understood as the framework by which corporate entities are directed and controlled (Cadbury, 1992). Governance mechanisms are intended to align managerial objectives with shareholder interests, reduce agency costs, and enhance firm value (Jensen & Meckling, 1976). The adoption of sound governance practices has been linked to improved transparency, risk management, and investor confidence (Solomon, 2017). These issues are particularly salient in emerging economies where institutional frameworks are evolving and enforcement remains inconsistent (Claessens & Yurtoglu, 2013).

In Sri Lanka, governance reforms have been introduced progressively since the late 1990s, primarily led by the Institute of Chartered Accountants of Sri Lanka (ICASL) and market regulators such as the Securities and Exchange Commission (SEC). The Code of Best Practice on Corporate Governance, first introduced by ICASL in 1997 and subsequently updated in 2003 and 2008, advocates for board independence, separation of leadership roles, and establishment of board committees (ICASL, 2008). These guidelines seek to improve decision-making quality and accountability among listed firms.

Despite these reforms, it is not immediately clear whether formal compliance with governance codes translates into meaningful improvements in financial outcomes. Prior research in developed markets often yields mixed results, with governance variables exhibiting positive, negative, or insignificant effects on firm performance (Bhagat & Bolton, 2008; Brown & Caylor, 2009). In emerging markets, contextual factors such as ownership concentration, regulatory quality, and cultural norms further complicate the governance–performance relationship (Aguilera et al., 2008).

## 1.2 Problem statement/ study problem

Corporate governance has emerged as a central theme in discussions on organizational effectiveness, transparency, and accountability. In theory, well-structured governance mechanisms—such as board independence, separation of leadership roles, and active board committees—should enhance decision-making quality, reduce agency conflicts, and ultimately improve financial performance (Jensen & Meckling, 1976; Bhagat & Bolton, 2008). Policymakers, regulators, and professional bodies in Sri Lanka, including the Institute of Chartered Accountants of Sri Lanka (ICASL) and the Securities and Exchange Commission (SEC), have promoted corporate governance reforms through codes of best practice and mandatory reporting requirements (ICASL, 2008).

Despite these initiatives, the effectiveness of corporate governance in actually influencing firm performance in Sri Lanka remains unclear. Prior studies provide mixed results. Some research suggests that board-level attributes, such as size, independence, and committee structures, may improve performance (Kumudini & Anoma, 2012), while other studies find negligible or statistically insignificant relationships (Velampy, 2013; Senaratne, 2007).

These discrepancies may arise from:

1. **Contextual Factors** – Sri Lanka’s corporate sector is characterized by concentrated ownership, family-controlled firms, and relationship-based governance, which may weaken the monitoring role of formal governance structures.
2. **Methodological Differences** – Previous studies vary in their sample selection, time periods, and choice of performance metrics (accounting-based vs. market-based), leading to inconsistent findings.
3. **Limited Scope** – Much of the existing research is sector-specific (e.g., manufacturing or banking) and may not generalize across the broader non-financial sector listed on the Colombo Stock Exchange (CSE).
4. **Compliance vs. Performance Orientation** – Firms may adopt governance mechanisms primarily to comply with regulations rather than to enhance operational or financial performance, limiting the observable effect on profitability indicators.

Given this uncertainty, there is a **critical research gap** in understanding whether governance mechanisms meaningfully influence firm performance in Sri Lanka, particularly for non-financial listed companies over a sustained period. Addressing this gap is important for

policymakers, investors, and boards of directors who seek to strengthen governance frameworks while ensuring they contribute to tangible business outcomes.

### **1.3 Research questions**

To address the above problem, this study formulates the following research questions:

1. To what extent do non-financial listed companies in Sri Lanka adopt board-level corporate governance practices, including board size, board composition, CEO duality, and the establishment of board committees?
2. How are selected governance mechanisms associated with accounting-based performance indicators (ROA and ROE) in the Sri Lankan context?
3. Do board-level governance structures significantly influence firm profitability and efficiency, or do they function primarily as compliance mechanisms?
4. How might ownership concentration, regulatory enforcement, and institutional quality mediate or moderate the relationship between governance mechanisms and firm performance?
5. What recommendations can be drawn to improve governance practices so that they positively contribute to firm performance in emerging markets like Sri Lanka?

### **1.4 Research Objectives**

#### **Main Objective**

To investigate the effect of board-level corporate governance mechanisms on the financial performance of non-financial companies listed on the Colombo Stock Exchange (CSE), Sri Lanka.

#### **Specific Objectives**

1. To examine the extent of adoption and implementation of key board-level corporate governance practices—including board size, board composition, CEO duality, and the establishment of board committees—among non-financial companies listed on the Colombo Stock Exchange (CSE).
2. To analyze the relationship between selected corporate governance mechanisms and firm financial performance, measured using accounting-based indicators such as Return on Assets (ROA) and Return on Equity (ROE).
3. To evaluate the impact of board-level governance attributes on firm profitability and operational efficiency, and to assess whether these mechanisms function as performance-enhancing structures or primarily as compliance-based requirements.

4. To investigate the moderating or mediating role of contextual factors, including ownership concentration, regulatory enforcement, and institutional quality, in the relationship between governance mechanisms and firm performance in Sri Lanka.
5. To propose evidence-based recommendations to strengthen corporate governance practices, ensuring that board-level mechanisms contribute effectively to improved financial performance within emerging market settings such as Sri Lanka.

## **2. LITERATURE REVIEW AND THEORETICAL FRAMEWORK**

### **2.1 Theoretical Perspectives on Corporate Governance**

Corporate governance research is grounded in multiple theoretical frameworks that explain why governance mechanisms exist and how they influence firm outcomes. These theories offer contrasting predictions regarding the role of boards, leadership structures, and oversight practices in enhancing organizational performance.

#### **Agency Theory**

Agency theory, introduced by Jensen and Meckling (1976), is one of the most widely cited frameworks in corporate governance research. It argues that separation of ownership and management creates principal-agent conflicts, where managers (agents) may pursue personal objectives rather than maximizing shareholder wealth (Eisenhardt, 1989). Such conflicts can result in inefficient investment decisions, opportunistic behavior, and reduced firm value. To mitigate these risks, agency theorists recommend several governance mechanisms:

- Board independence: Inclusion of non-executive or independent directors helps monitor managerial behavior and reduce agency costs.
- Separation of CEO and chair roles: Distinguishing leadership roles ensures checks and balances, preventing excessive managerial control over the board.
- Board committees: Audit, remuneration, and nomination committees facilitate detailed oversight and reinforce accountability (Fama & Jensen, 1983).

Agency theory assumes that formal mechanisms are necessary to enforce monitoring, especially in contexts with weak shareholder rights or concentrated ownership structures.

#### **Resource Dependence Theory**

Resource dependence theory (Pfeffer & Salancik, 1978) presents a complementary perspective, emphasizing the strategic and advisory functions of boards. Boards are not just monitoring bodies but also providers of critical resources, including:

- Access to financial capital and external networks

- Expertise for strategic decision-making
- Legitimacy in the eyes of stakeholders and regulators

From this perspective, board size, diversity, and external linkages enhance organizational resilience and support long-term performance. Unlike agency theory, which focuses primarily on controlling managerial opportunism, resource dependence theory underscores the proactive role of boards in value creation.

### **Stewardship Theory**

Stewardship theory (Davis et al., 1997) offers an alternative view, suggesting that managers are inherently motivated to act in the best interests of the firm due to intrinsic satisfaction, professional reputation, and long-term career considerations. Unlike agency theory, stewardship theory contends that strict monitoring may be counterproductive if it undermines managerial autonomy and trust. Key implications include:

- CEO duality (when the CEO also serves as board chair) may not reduce firm performance; instead, unified leadership can facilitate faster decision-making and strategic alignment.
- Emphasis on empowerment and collaboration rather than purely compliance-driven governance mechanisms.

These competing theoretical perspectives indicate that the effectiveness of governance mechanisms is context-dependent, varying by ownership structure, regulatory environment, and cultural norms. In Sri Lanka, where family-controlled firms dominate, stewardship considerations may be as relevant as agency concerns (Wellalage & Locke, 2012).

## **2.2 Empirical Evidence**

Empirical research on corporate governance and firm performance demonstrates considerable heterogeneity, reflecting both theoretical nuances and contextual differences.

### **International Evidence**

- Positive effects: Studies in developed markets frequently report that independent directors, active board committees, and separation of leadership roles enhance firm performance. Bhagat and Bolton (2008) found that boards with higher proportions of independent directors exhibit stronger oversight, resulting in better profitability and

shareholder returns. Shleifer and Vishny (1997) similarly highlight that effective monitoring improves investment efficiency and reduces managerial opportunism.

- Insignificant or mixed effects: Adams and Mehran (2003) and Dalton et al. (2003) observe that board composition and CEO duality often do not significantly predict firm performance. In some cases, formal compliance with governance codes does not translate into effective oversight.
- Negative or context-specific effects: Claessens and Yurtoglu (2013) argue that in countries with concentrated ownership and weak minority shareholder rights, formal governance mechanisms may be symbolic, serving more to satisfy regulatory requirements than to improve operational efficiency. This underscores the importance of institutional and cultural context in determining governance effectiveness.

### **Empirical Evidence from Sri Lanka**

Research in Sri Lanka largely mirrors international findings but highlights context-specific challenges:

- Velnampy (2013) investigated governance practices in Sri Lankan manufacturing firms and reported no significant correlation between board characteristics and performance metrics (ROA, ROE).
- Kumudini and Anoma (2012) analyzed listed non-financial companies and observed weak associations between board size, independence, and performance.
- Senaratne (2007) examined the evolution of corporate governance codes in Sri Lanka and noted that compliance levels improved over time, but actual performance outcomes were inconsistent, particularly in family-controlled firms where formal structures often coexist with relational decision-making norms.

Collectively, these studies indicate that while Sri Lankan companies generally adopt governance mechanisms consistent with international codes, the impact on financial performance remains inconclusive. Factors such as family ownership, concentrated shareholding, and informal decision-making processes may diminish the effectiveness of formal governance structures. Moreover, limited resources and evolving regulatory enforcement in emerging markets may hinder boards' ability to implement meaningful oversight (Velnampy & Pratheepkan, 2012; Wellalage & Locke, 2012).

### 3. MATERIALS AND METHODOLOGY

#### 3.1 Research Design

This study employs a **quantitative, explanatory research design** to assess the governance–performance relationship. The approach combines:

- **Descriptive statistics** to summarize governance characteristics and performance indicators.
- **Correlation analysis** to explore bivariate relationships between governance variables and firm performance.
- **Multiple regression analysis** to examine the influence of board-level governance attributes on performance, controlling for other factors.

The design allows for testing of hypothesized relationships and provides evidence of both the direction and magnitude of effects.

#### 3.2 Sampling Technique and Data Sources

The study focuses on **non-financial companies listed on the Colombo Stock Exchange** during the period **2015–2019**. Financial institutions were excluded due to distinct regulatory requirements and accounting standards that could bias comparisons.

- **Sample Selection:** A **purposive sampling** approach was applied to select 100 companies that represent a wide range of sectors, ensuring coverage of large- and mid-cap firms. The final sample accounts for approximately **56% of total market capitalization** of non-financial listed companies, making it representative of the population.
- **Data Sources:** Secondary data were collected from:
  - Audited annual reports of listed firms.
  - Official filings and disclosures from the CSE.
  - Corporate websites and other published documents.

To ensure **accuracy and consistency**, all data points were cross-checked across multiple sources.

#### 3.3 Conceptual Framework

The study adopts a **board-level governance perspective**, focusing on mechanisms recommended in international and Sri Lankan governance codes. The conceptual model posits that firm performance is influenced by four key governance attributes:

- **CEO Duality (DUAL):** Separation of CEO and board chair roles to enhance monitoring.

- **Board Size (B-SIZE):** Total number of directors to balance oversight with decision-making efficiency.
- **Board Composition (NON-EX):** Proportion of non-executive directors as a measure of independence.
- **Board Committees (B-COMT):** Number of active committees (audit, nomination, remuneration) supporting governance functions.

The framework assumes that effective governance improves monitoring, strategic guidance, and accountability, which in turn may enhance financial performance (ROA and ROE).

### Econometric Model

To examine the impact of board-level governance on firm performance, the following multiple regression model is specified:

$$PER_{it} = \alpha + \beta_1 DUAL_{it} + \beta_2 B\text{-}SIZE_{it} + \beta_3 NON\text{-}EX_{it} + \beta_4 B\text{-}COMT_{it} + \epsilon_{it}$$

Where:

- $PER_{it}$  = Performance measure for firm *iii* at time *ttt* (ROA or ROE)
- $DUAL_{it}$  = CEO duality indicator
- $B\text{-}SIZE_{it}$  = Board size.
- $NON\text{-}EX_{it}$  = Proportion of non-executive directors.
- $B\text{-}COMT_{it}$  = Number of board committees
- $\alpha$  = Intercept term.
- $\epsilon_{it}$  = Error term

### 3.4 Data Analysis Technique

The collected panel data were analyzed using SPSS. Analytical techniques included:

1. Descriptive Statistics: Summarize the distribution of governance attributes and performance measures.
2. Spearman Correlation Analysis: Examine bivariate associations between governance variables and performance.
3. Multiple Regression Analysis: Assess the direction, magnitude, and significance of governance attributes on ROA and ROE, controlling for other factors.

This methodological approach allows testing of the study's hypotheses while providing robust insights into governance-performance relationships in the Sri Lankan context.

### 3.5 Hypothesis

This study proposes that effective corporate governance mechanisms influence firm performance by enhancing oversight, accountability, and strategic decision-making (Bodaghi & Ahmadpour, 2010; Shleifer & Vishny, 1997). The hypotheses focus on board-level attributes commonly recommended in governance codes, including CEO duality, board committees, board size, and board composition.

#### **H1: CEO Duality and Firm Performance**

Separation of CEO and Board Chair roles strengthens monitoring and reduces conflicts of interest, leading to better performance.

#### **H2: Board Committees and Firm Performance**

Active committees (audit, nomination, remuneration) improve governance quality and oversight, positively affecting firm outcomes.

#### **H3: Board Size and Firm Performance**

An appropriately sized board balances expertise and decision-making efficiency, potentially enhancing performance.

#### **H4: Board Composition and Firm Performance**

A higher proportion of independent, non-executive directors increases oversight and transparency, contributing to improved firm performance.

These hypotheses provide a framework to test how key governance mechanisms relate to financial performance in Sri Lankan non-financial listed companies.

## 4. RESULTS AND DISCUSSION

### **a. Descriptive analysis**

The descriptive analysis provides insights into the governance practices adopted by non-financial companies listed on the Colombo Stock Exchange during 2015–2019. The findings indicate that the **average board size** among sampled firms is approximately eight directors, which aligns with international best practices recommending moderately sized boards to balance decision-making efficiency with diverse expertise (OECD, 2015; Yermack, 1996).

The **mean proportion of non-executive directors** is 68%, suggesting that a majority of firms maintain a relatively strong formal representation of independent oversight. Additionally, most firms observe the **separation of CEO and Board Chair roles**, indicating

compliance with governance code recommendations and reflecting efforts to mitigate potential agency conflicts (Fama & Jensen, 1983).

Despite these positive trends, the **implementation of specialized board committees**—such as audit, nomination, and remuneration committees—varies significantly across firms. Some organizations maintain fewer than the recommended number of committees, which may limit the effectiveness of board oversight functions (Abbott et al., 2004). Overall, the descriptive statistics suggest that while firms formally adopt governance mechanisms, there is heterogeneity in the depth and quality of implementation.

### **b. Regression Analysis**

Multiple regression results reveal that the four selected governance attributes—CEO duality, board size, board composition, and board committees—collectively explain approximately 15% of the variation in firm performance, as measured by Return on Assets (ROA) and Return on Equity (ROE). However, none of the individual governance variables are statistically significant at conventional levels ( $p < 0.05$ ).

- Approach may limit the effectiveness of boards in influencing financial **Board independence** exhibits a positive directional coefficient, indicating that a higher proportion of non-executive directors is associated with better performance. However, this effect is not statistically robust.
- **CEO duality** and **board size** show minimal impact on financial performance, suggesting that simply separating leadership roles or adjusting board size may not translate into measurable profitability gains in this context.
- The **number of board committees** does not display a meaningful association with ROA or ROE, indicating that the mere existence of committees may not guarantee effective oversight or improved operational outcomes.

These findings resonate with prior research from other emerging markets, where formal adoption of governance mechanisms often shows limited influence on firm performance (Aguilera et al., 2018; Velnampy, 2013). The results highlight that compliance with governance codes does not necessarily equate to enhanced financial outcomes.

### **c. Interpretation and Contextual Analysis**

Several contextual factors help explain the observed weak relationships between governance practices and firm performance in Sri Lanka:

### 1. Concentrated Ownership Structures

A significant proportion of listed firms are controlled by large shareholders or family groups, which may reduce the monitoring power of independent directors (La Porta et al., 1999). In such settings, governance mechanisms might exist in form but not in function, as key strategic decisions are influenced by dominant stakeholders.

### 2. Regulatory Compliance vs. Substantive Oversight

Many firms appear to adopt governance mechanisms primarily to comply with statutory or voluntary guidelines rather than to strengthen internal control or strategic decision-making (Tricker, 2015). This formalistic outcomes.

### 3. External Economic and Sectoral Factors

Macroeconomic conditions, industry-specific dynamics, and global market fluctuations may exert a stronger impact on profitability than internal governance structures. For instance, firms operating in highly competitive or volatile sectors may face performance constraints irrespective of board effectiveness.

### 4. Governance Implementation Quality

Even where governance mechanisms exist, their actual execution may be limited. Board committees may meet infrequently, and non-executive directors may lack sufficient engagement or expertise to influence strategic decisions effectively. This gap between **formal adoption and practical application** reduces the potential impact on performance.

#### Synthesis:

The analysis suggests that governance mechanisms in Sri Lanka may currently serve **symbolic and compliance-oriented roles** rather than acting as drivers of profitability or operational efficiency. While formal structures such as independent boards and CEO-chair separation align with global recommendations, their practical influence is constrained by ownership patterns, regulatory enforcement limitations, and contextual economic factors.

The findings highlight the importance of considering **institutional and market-specific factors** when evaluating governance-performance relationships. Future research should examine not only the presence of governance structures but also their quality, director engagement, and interaction with ownership concentration to better understand performance outcomes in emerging market contexts.

## 5. CONCLUSION

This study investigates the relationship between corporate governance practices and firm performance in Sri Lanka's non-financial listed sector. Despite evidence of formal compliance with governance codes, selected governance attributes (CEO duality, board size, board composition, and board committees) do not significantly influence accounting-based performance outcomes.

The limited explanatory power of these variables suggests that governance structures alone may be insufficient to drive profitability in contexts characterized by concentrated ownership and evolving institutional quality.

Future research should incorporate market-based performance indicators, ownership structure controls, and longitudinal methods to provide a more comprehensive understanding of governance effectiveness in emerging markets.

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