

Effect of corporate governance on stock return in firms listed in Colombo Stock Exchange

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Abstract

Despite the enormous attention that corporate governance received following a series of corporate scandals, the effectiveness of prevailing governance best practices in achieving intended objectives remains a puzzle. Therefore, this study assesses the association between corporate governance and stock returns using the data on a sample of 100 firms listed in the Colombo Stock Exchange for the five years from 2016 to 2020. Four corporate governance sub-indices were formulated to measure the level of corporate governance compliance by classifying 18 board-related best practices into four sub-indices where each best practice is given the same weight. Capital gain, dividend, and total stock return were used as proxies for stock return. A series of random-effects panel regression models used in this study to analyse the data did not show adequate evidence to claim a positive association between stock return and corporate governance compliance. Only the basic board-related best practices show a weak positive impact on stock return. The main reason behind this finding could be the concentrated and family ownership structure prevailing in a large number of smaller firms in Sri Lanka. More precisely, the Sri Lankan firms have maintained satisfactory levels of stock return even when they do not comply with the corporate governance best practices. These findings highlight the necessity of formulating contextually relevant best practices instead of encouraging firms to comply with practices deemed best in developed markets.

Keywords:- Agency theory, Corporate governance, Sri Lanka, Stock return

1 Introduction

Generally, a positive association between corporate governance and firm performance is well-established in the literature. If this positive association is material and is fully integrated into the stock market, any favourable change in corporate governance compliance of a firm should be reflected in a favourable change in share prices (Gompers, Ishii, & Metrick, 2003). Moreover, as per popular belief, firms with better corporate governance should perform better (Hermuningsih, Kusuma, & Cahyarifida, 2020; Kyere & Ausloos, 2020; Naimah & Hamidah, 2017). The investors and other stakeholders assess the credibility of a firm

based on the firm performance because firm performance shows the efficiency and effectiveness of the formal efforts of the firm in attaining its goals (Hermuningsih et al., 2020). Hence, information on firm performance serves as a basis for deciding whether investors will keep or release their investments from the firm (Mursalim, Mallisa, & Kusuma, 2017). Therefore, in general, firms with better corporate governance should be associated with higher stock returns.

Few empirical studies such as Bhagat and Black (2001), and Hermalin and Weisbach (2003) deny the existence of any favourable effect on a firm's valuation from effective corporate governance. On the other hand,

some literature suggests that better corporate governance enhances firms' market value (Black, 2001; Gompers et al., 2003; Malik, 2012; Mubarak & Hamdan, 2016). This inconsistent outcome may be mainly attributed to the contextual backgrounds of each country (Black, 2001), and different approaches that have been adopted for measuring corporate governance compliance in each study. Moreover, conventional literature suggests that the popular codes of best practices on corporate governance rely highly on the claims made in agency theory concerning organisations where there is a substantial diffusion of ownership and a separation of ownership from management (Bhagat & Black, 2001; Hermalin & Weisbach, 2003).

In light of a series of recent corporate failures like WorldCom, Enron, and the US subprime mortgage crisis, researchers and policymakers worldwide have started revisiting the corporate governance guidelines (Brown & Caylor, 2006). The failures of Golden Key Credit Card, Pramuka Bank, and SR Property Sharing Investment are a few cases reported in Sri Lanka which have been directly attributed to agency conflicts and poor corporate governance (Azeez, 2015; Jayasinghe & Kumara, 2020; Kalainathan & Vijayarani, 2014; Sameera, 2020). In addressing these issues, in 1997, Sri Lanka introduced its first formal code of best practice on matters related to financial aspects of corporate governance, based on the British governance code introduced in 1992. This code was modified subsequently in 2003, 2008, 2013 and 2017. Nevertheless, none of these codes have yet been made mandatory in Sri Lanka.

In Sri Lanka, most of the listed firms are characterised by concentrated and family ownership (Hewa Wellalage & Locke, 2014; Manawaduge, 2012). The legal protection for minority shareholders in such firms is limited in such markets, given the weak rules and regulations and poor institutional and organisational quality. Hence, there is more room for principal-principal conflicts (i.e., between larger and smaller shareholders) than the conventional agency conflict between owners and managers. These characteristics make Sri Lanka an exciting and unique context for corporate governance studies. However, only a handful of studies in Sri Lanka have examined the effect of corporate governance on stock return. Therefore, this study assesses the impact of corporate governance on stock return using a more recent panel dataset on 100 firms listed in the Colombo Stock Exchange (CSE), where four sub-indices were used to measure corporate governance.

The use of sub-indices and an extensive dataset covering a five-year period can be identified as the key contributions of this study. Due to these attempts, not only can the effect of different categories of corporate governance best practices be explored, but also the effects can be observed over an extended period.

2 Literature Review

Modern organisations are like republics; the shareholders with ultimate authority elect agents to manage the firm on their behalf (Gompers et al., 2003). Nevertheless, this separation of control and ownership, given the self-interested nature of agents, creates a potential conflict of interest between shareholders and managers, which is well-

known as agency conflict (Jensen & Meckling, 1976). The absence of adequate monitoring mechanisms and incentives encourage managers to abuse the shareholders' funds to satisfy their own interest (Nguyen, Doan, & Nguyen, 2020). More precisely, the managers may misuse the owners' wealth for their benefit by revealing insider information of the firm to outsiders expecting undue benefits from third parties, wasting corporate resources by unnecessary consumption of perquisites, and making suboptimal decisions (Anderson & Reeb, 2004; Shleifer & Vishny, 1997).

The actual power-sharing relationship between managers and shareholders depends on the specific governance rules and distribution of property rights (Gompers et al., 2003). Fremond and Capaul (2002) state that the property rights of shareholders need to be well established through corporate governance regulations for a company to function efficiently. Accordingly, better corporate governance practices, for example, separated roles of chairman and CEO, independent boards, frequent board meetings, and independent board sub-committees, can reduce the undue power concentration with the CEO while enhancing the board's capacity of advising and monitoring (Adam Hermalin, & Weisbach, 2010; Fernandes, Farinha, Martins, & Mateus, 2021; Hermalin & Weisbach, 2003; Rashid, 2018). This situation, in turn, mitigates a firm's susceptibility to crises, reduces the cost of capital, enhances access to outside capital, and reduces the corruption and looting of firm resources by the management.

In situations where firms are characterised by concentrated ownership or family ownership, in addition to this agency

conflict, a conflict of interest can emerge between family owners and external shareholders (i.e., between controlling and minority shareholders) creating a potential risk of expropriating weaker shareholders by influential shareholders (Liu & Tian, 2012; Shleifer & Vishny, 1997). The resulting agency costs generally lead to poor firm performance. Hence, corporate governance has emerged as a mechanism to control the opportunistic behaviours of managers and ensure accountability towards all the investors (Azeez, 2015).

In contrast, some studies show that owner-managers in concentrated or family-owned firms have better incentives to act in the firm's best interest because of their aligned interests (Anderson & Reeb, 2004; Azizi, Bidgoli, & Taheri, 2021; Jensen & Meckling, 1976; Minh Ha, Do, & Ngo, 2022; Muntahanah, Kusuma, Harjito, & Arifin, 2021). Azizi et al. (2021) have stated that owner managers being good stewards create no agency costs to the firms enabling the resources, otherwise spent on monitoring and controlling, to be utilised in maximising the firm performance. As stewardship theory claims, not only the owner-managers, but also non-owner managers are not necessarily opportunistic but are motivated to manage the firm in the best interest of shareholders owing to intrinsic rewards (Donaldson & Davis, 1991). More precisely, concentrated ownership may enhance the stewardship behaviour of owner-managers. Further, the agency costs mainly resulting from information asymmetry are likely to be reduced given the high ownership stakes and close ties between family owners (Jiang & Peng, 2011; D'Este &

Carabelli, 2022). Gompers et al. (2003) have indicated that access to capital in emerging markets characterised by weaker market-supporting institutional frameworks is basically through private and informal channels and not through formal channels like banks or capital markets. Further, some studies show that firms with concentrated or family ownership experience lower agency costs due to lowered information asymmetry (Guluma, 2021; Jiang & Peng, 2011; Nguyen et al., 2020). Hence, owner-managers are more advantageous to the firms in gaining access to unique resources and capital than professional managers (Jiang & Peng, 2011). Therefore, even the minority shareholders can be benefited from concentrated ownership.

Corporate governance best practices mainly aim to create more democratic boards that can control executives' opportunistic behaviour and protect shareholder rights by participative decision-making. Conflicting empirical evidence indicates that these best practices may not be effective in all contextual settings. Importantly, what constitutes best practices of corporate governance remains a puzzle. Therefore, evaluating the potential of each best practice to create a favourable investor perception of the firm is worthy when claiming an association between corporate governance and stock return (Fernando & Dissabandara, 2018). For example, combining the role of CEO and chairman results in a dominant CEO with concentrated power, and thus, the monitoring function of the board becomes ineffective, and the decision control of the board of directors becomes weak (Morck, Shleifer, & Vishny, 1989). Boards in such firms are more likely to manipulate the

firm's earnings (Dechow, Sloan, & Sweeney, 1996). In contrast, separating the roles of chairman and CEO separates the decision management and decision control, eventually leading to control the agency problem and enhanced firm performance (Fama & Jensen, 1983).

Moreover, firms with independent boards usually have higher ratings in the corporate governance indices (Yasser, Entebang, & Mansor, 2011), making them attractive for investors. For example, non-executive directors are more concerned about maintaining their reputation, and thus they are encouraged to safeguard the interest of shareholders (Fama & Jensen, 1983). Therefore, boards dominated by non-executive directors fulfil their monitoring role more effectively (Beasley, 1996).

Board meeting frequency, being another vital dimension in corporate governance, contributes to improve firms' performance because frequent meetings enhance the capacity of the board in advising, monitoring and disciplining management (Ntim & Oseib, 2011). Frequent board meetings help improve the board's efficiency and effectiveness because board members who attend those meetings are fully furnished with all the relevant information required for futuristic decision-making (Eluyela et al., 2018). Hence, higher board meeting frequency enhances the firm performance (Vafeas, 1999a).

The decisions concerning executives' selection, their remuneration, and other prerequisites are decided at the board of directors' discretion. Even though the selection of external auditors is at the discretion of shareholders (Malik, 2012), even this decision can be influenced by

the influential shareholders holding managerial positions, especially in firms with concentrated ownership. Poor decisions concerning board nominations and remunerations can have severe and long-lasting consequences on the firm performance. Hence, board sub-committees act as an additional control mechanism which encourages accountability and protection of shareholder interests (Cadbury et al., 1992). The audit committee basically works on mitigating information asymmetry and frauds by continuously reviewing the audit processes and internal controls. Further, the audit committee allows timely disclosures that ultimately results in increased investor confidence and firm value (Klein, 1998). According to Agyemang-Mintah (2016), establishing an independent remuneration committee helps structure the executive rewards in a manner that is consistent with the shareholders' interests. Moreover, the nomination committee strengthens the board and reduces agency problems by appointing appropriate directors and enhancing board independence (Vafeas, 1999b). According to Nwokwu, Atapattu, and Azeez (2019) achieving the sub goals of these board sub-committees sum up to attain the overall organisational goal. Hence, the existence, expertise and independence of board sub-committees such as the nominations committee, audit committee and remuneration committee can determine firm performance, investor confidence, and ultimately the stock return.

Since this study focuses on the corporate governance effect on the stock return, examining the bottom-line effects of corporate governance on stock prices and

dividend are worthy. Higher stock prices indicate a higher corporate value. The stock price depends on the demand and supply (Christopher, Rufus, & Ezekiel, 2009), which depends on the firm performance and quality of management. The agency theory argues that corporate governance reduces agency costs and enhances firm performance. If this relationship between corporate governance and performance is material and fully integrated into the stock market, then the share price should quickly adjust upward to any favourable change in the corporate governance practices (Gompers et al. 2003). Further, Black, Jang, and Kim (2006) argued that even though better-governed firms are not always associated with higher profits or dividends, in general, the market values the same earnings and dividends of a better-governed company more highly due to the reduced risk. Along with these arguments, many empirical studies support this positive association between corporate governance and firms' market value or stock prices (Black, 2001; Malik, 2012). Nevertheless, studies denying the existence of such favourable effects of corporate governance on a firm's valuation are not scarce (Bhagat & Black, 2001; Hermalin & Weisbach, 2003).

Concurrently, two contrasting theories, namely outcome theory and substitution theory of dividend, explain the association between corporate governance and dividend. Proponents of the outcome hypothesis claim that the quality of corporate governance positively affects dividend payments. Jensen (1986) has argued that dividend payments reduce the free cash flows of the firms that managers could otherwise use for their own

benefits. Hence, dividend payments tend to drop as agency costs rise. However, shareholders with strong rights in firms with better corporate governance can pressure the management to pay higher dividends while preventing the misuse of free cash flows for their own benefits (Jensen & Meckling, 1976; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998). Empirical evidence is also available to claim a positive association between corporate governance and dividend payouts as stipulated in the outcome model of dividend in emerging countries (Mitton, 2004) and developed countries (Brown & Caylor, 2006; Farinha, 2003). In contrast, the substitution hypothesis of dividends views corporate governance as a substitute for dividends (Suhadak, Kurniaty, Handayani, & Rahayu, 2019) because higher investor protection reduces investor risk perceptions. Hence firms with sound corporate governance practices tend to pay low dividends (John & Knyazeva, 2006).

This literature review summarised in Table 2, shows that neither the theoretical association between corporate governance and stock return nor the empirical are consistent. For example, not only the existence of two frequently upheld theories namely agency theory and stewardship theory can be observed, but also there is a substantial division in the empirical evidence. More precisely, some studies have reported a positive effect of corporate governance on a firm's stock return (Black et al., 2006; Brown & Caylor, 2006; Gompers et al., 2003; Giroud & Mueller, 2011; Malik, 2012; Mohamed & Elewa, 2016). Others have reported a negative effect (Kouwenberg, Salomons, &

Thontirawong, 2014; Kurniati, 2019), while Fernando and Dissabandara (2018) have found no significant effect of corporate governance on stock returns. Therefore, examining whether the level of compliance with corporate governance best practices affects a firm's stock return is necessary.

1. Methods

This study examines the association between corporate governance and stock return based on the data for the five years from 2016 to 2020. A sample of 100 firms was selected out of the 206 non-financial firms listed in the CSE as of 31st March 2021 using the systematic random sampling technique to ensure that the sample spreads across all sizes of firms because the generalizability of findings may be impaired if the sample only consists of firms of similar size (Eisenberg, Sundgren, & Wells, 1998). Here, from a total of 282 firms listed in the CSE as at the above date, 76 firms belonging to the financial sector and six firms for which the annual reports were not available on a continuous basis were excluded. This exclusion of financial sector firms was made mainly due to the unique conditions prevailing in this sector. Therefore, the final sampling frame consisted of 200 firms. In order to select a sample of 100 firms, a sampling interval of two was used. The sampling was made after sorting all the firms based on their size. Along with the claims made in agency theory, this study hypothesizes that better corporate governance leads to higher stock return.

The level of compliance with corporate governance was measured using four sub-indices formulated considering 18 board-related best practices of the Sri Lanka Code of

Best Practice on Corporate Governance 2017. These best practices were organised into four corporate governance sub-indices, namely: Basic Board (BB), Remuneration Committee (RC), Audit Committee (AC), and Nomination Committee (NC). Employing corporate governance sub-indices that capture distinct aspects of governance enabled the study to identify which element of corporate governance is more relevant in improving investor confidence and stock returns (Javaid, 2015). Based on some of the literature reliant on the index approach, equal weights were assigned in this study to each best practice (Bebchuk, Cohen, & Ferrell, 2004; Gompers et al., 2003). Here, a value of one was assigned if a firm complies with a particular best practice,

otherwise, a value of zero was assigned. The value of each sub-index was determined by taking the sum of the values assigned to each of the best practices falling under the relevant sub-index.

Stock return was measured using three measures; capital gain (CGain), dividend (Div) and total stock return (TSR). Even though some studies have used year-beginning share price and year-end share price for such calculations, this study used the annual average of the daily closing share prices similar to Malik (2012). For example, Div is the amount of dividend paid for a stock during the year. CGain is the ratio of the difference in average share prices relative to the average share price of the previous year.

Table 1: Composition of corporate governance sub-indices

Sub-Index	Maximum Value	Best Practice
Basic Board (BB)	4	CEO & chairman duality At least 33% of NEDs on the board At least 66% of the board are independent NEDs Board met at least once every quarter
Remuneration Committee (RC)	5	Presence of remuneration committee The chairman of RC is an independent NED RC entirely consists of NEDs RC is comprised of a minimum of three NEDs The majority of RC is independent NEDs
Audit Committee (AC)	5	Presence of audit committee The chairman of AC is an independent NED AC entirely consist of NEDs AC is comprised of a minimum of three NEDs The majority of AC are independent NEDs
Nomination Committee (NC)	4	Presence of Nomination Committee The chairman of NC is an independent NED The majority of the NC are NEDs At least 33% of the NC are independent NEDs

Note: CEO stands for Chief Executive Officer, and NED stands for non-executive directors

Table 2: Approaches used in the literature

Study	Dependent Variable	CG Measurement	Control Variables	Effect of CG
Brown and Caylor (2006)	Tobin's Q	Gov-Score	Assets, Firm Age Delaware dummy	Positive
Gompers et al. (2003)	Tobin's Q Net Profit Margin ROE, Sales Growth	Governance Index	Incorporation in Delaware Assets, Firm age	Positive
Malik (2012)	Share price	Corporate Governance Score	N/A	Positive
Fernando and Dissabandara (2018)	Share price	Corporate Governance Index with five sub-indexes namely Board structure, CEO and Management, Transparency and Disclosure, Investor Relation and CSR Disclosure	Firm size	No relationship
Kouwenberg et al. (2014)	Stock return	Four governance portfolios (CG1, CG2, CG3, CG4) with equal weights	Country effects, Systematic risk Industry effects	Negative
Kurniati (2019)	Stock return (consisting of abnormal returns and dividend yield)	Proportion of independent commissioners, institutional ownership, managerial ownership, and public ownership	N/A	Negative
Mitton (2004)	Dividend payout ratio	Credit Lyonnais Securities Asia (CLSA) Composite Score	Growth Profitability Size	Positive

Note: CG stands for Corporate Governance

Firm size and leverage were used as control variables of the study. Here, the firm size was measured using the natural logarithm of total assets similar to Dogan (2013), and the leverage was measured using the debt-to-assets ratio similar to Azeez (2015). Some of the studies which share common characteristics with this study are summarised in Table 2.

$$SR_{it} = \alpha + \beta_1 BB_{it} + \beta_2 RC_{it} + \beta_3 AC_{it} + \beta_4 NC_{it} + \beta_5 SIZE_{it} + \beta_6 LEV_{it} + \lambda_t + \mu_{it} \text{ ----- (1)}$$

A random-effects panel regression model as specified in equation 1 was used as the primary analytical technique. The random-effects model was selected based on the Hausman test. In the equation, SR denotes a vector of stock return variables, where three separate models were fitted, each taking one of the stock return variables: CGain, Div and TSR. Further, since the data indicated serial correlation and heteroscedasticity, the random-effects model for each dependent variable was fitted using robust standard errors and bootstrapping as well yielding three models for each dependent variable. Therefore, altogether nine models were estimated. Since time fixed-effects were present, a vector of year dummies, denoted by λ , were also added to each model to account for time-variant characteristics. Error term and constant is indicated respectively by μ and α .

2. Findings and Discussion

As indicated by the All-Share Price Index (ASPI) in Figure 1, the stock returns have been gradually declining during 2015-2020. This drop in ASPI may be mainly attributed to the unstable political climate in the country during

this period. As a result of this market wide decline in stock returns, most of the firms have recorded negative stock returns as indicated in Table 3. Nevertheless, the stock prices have picked up since March 2020. This is the period when the country was severely affected by the COVID-19 pandemic. Therefore, this exceptional behaviour of the stock market is worth further study.

According to the four sub-indices of corporate governance, firms generally comply more with best practices related to basic board ($M = 2.977, SD = .768$), remuneration committee ($M = 4.463, SD = .688$), and audit committee ($M = 4.699, SD = .511$). However, firms' compliance with the best practices related to the nomination committee seems to be substantially lower ($M = 1.328, SD = 1.659$). This could be a consequence of the concentrated-family ownership in many listed firms in Sri Lanka where key managerial positions like chairman and CEO are held by few individuals in many cases having family relationships. However, empirical studies on these aspects relating to Sri Lanka are rare.

The Hausman test indicates the suitability of the random-effects model over the fixed-effects model ($\chi^2(10) = 1.400, p = .999$). The presence of the first-order autocorrelation was evidenced from the Wooldridge test for autocorrelation ($F(1,98) = 14.790, p < .001$) and presence of group-wise heteroskedasticity was evidenced from Modified Wald test ($\chi^2(99) = 9.7e+06, p < .001$). Therefore, in addition to the model with default standard errors, the regression model for each of the three stock return measures was estimated using robust standard errors and bootstrapping. This approach yielded nine regression models. As shown in Table 4, out

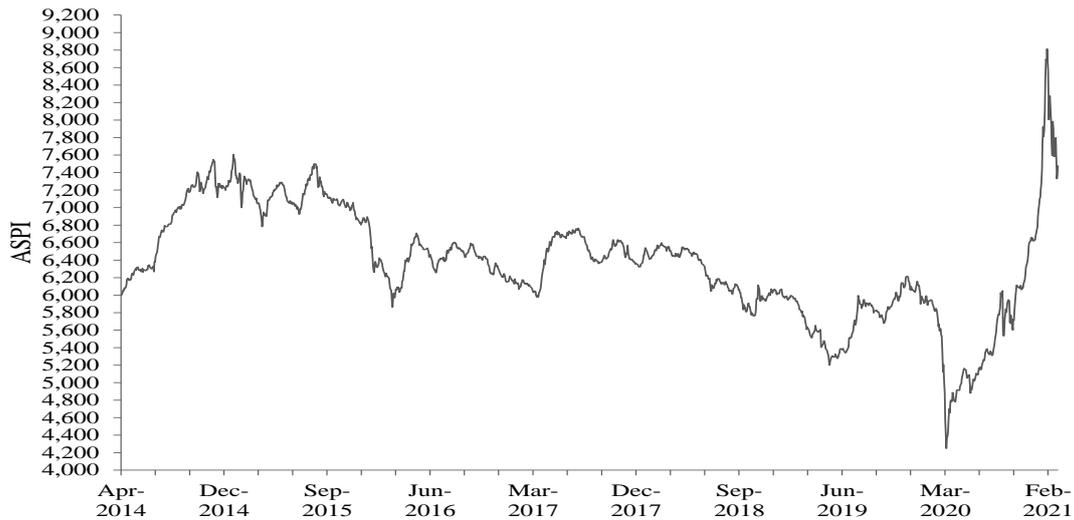


Figure 1: Variation in ASPI

of nine models, eight models were statistically significant except for the model-5 fitted using robust standard errors with *Div* as the dependent variable.

The first three models with *CGain* as the dependent variables indicated a statistically significant positive association (either at 5 or 10 percent significant levels) between basic board index and capital gain. None of the other corporate governance sub-indices showed a statistically significant association with capital gain. This was consistent with the findings of Javaid (2015) who found that compliance with corporate governance practices related to board structure positively affect stock return while board sub-committees have no influence on the stock return. The findings of Butar (2019) also confirms that the board sub-committees do not have any impact on stock returns. Moreover, none of the models showed evidence to claim any association between corporate governance sub-indices and dividends which was in consistent with the findings of Tahir, Sohail, Qayyam, and Mumtaz (2016). Two models with *TSR* as the dependent variable indicated a statistically significant positive association (at the 5

percent significant level) between basic board related best practices and total stock return in conformity with the findings of Singhchawla, Evans, and Evans (2011). Since *BB* was not associated with dividends, this positive association with *TSR* probably represents the positive association between *BB* and *CGain*. The presence of time-variant factors having a substantial influence on the stock returns was evidenced in all models except in dividend models. These time effects can be an indication of the highly volatile economic and political environment in Sri Lanka. Further, firm size did not show any association with stock returns in any of the models.

In summary, sufficient evidence is not available in this study to claim that better corporate governance leads to higher stock returns as generally expected in the corporate governance literature based on agency theory. This disassociation can be due to the lack of awareness about the benefits of these committees in particular or corporate governance in general. Nevertheless, the findings of this study are consistent with the findings of Black et al. (2006), Hamza and Mselmi (2017), Malik (2012), and Rosenstein

and Wyatt (1990) in the international context. Moreover, the findings are consistent with Fernando and Dissabandara (2018), who studied the effect of corporate governance among Sri Lankan investors. Sri Lankan investors are generally attracted to firms with well-established asset bases without considering governance quality. Further, these investors are easily influenced by giant

investors (Fernando & Dissabandara, 2018). Even though the findings contradict the predictions based on agency theory, they are consistent with the findings of Black et al. (2006). Hence, the share prices of firms in Sri Lanka are less likely to be responsive to the differences in governance quality (Fernando & Dissabandara, 2018).

Table 3: Descriptive Statistics

Variable		Mean	Std. Dev.	Min	Max	Observations
CGain	Overall	-0.066	0.210	-0.813	1.368	N = 486
	Between		0.108	-0.411	0.311	n = 100
	Within		0.182	-0.646	0.991	T bar = 4.86
Div	Overall	4.976	13.246	0.000	94.490	N = 466
	Between		11.230	0.000	82.070	n = 99
	Within		6.660	-15.564	78.926	T bar = 4.71
TSR	Overall	-0.033	0.220	-0.813	1.368	N = 463
	Between		0.133	-0.411	0.594	n = 99
	Within		0.184	-0.778	0.890	T bar = 4.68
BB	Overall	2.977	0.768	0.000	4.000	N = 480
	Between		0.604	1.400	4.000	n = 99
	Within		0.477	0.977	4.577	T bar = 4.85
RC	Overall	4.463	0.688	1.000	5.000	N = 482
	Between		0.561	1.000	5.000	n = 99
	Within		0.396	2.263	5.863	T bar = 4.87
AC	Overall	4.699	0.511	3.000	5.000	N = 482
	Between		0.414	3.400	5.000	n = 99
	Within		0.303	3.099	6.099	T bar = 4.87
NC	Overall	1.328	1.659	0.000	6.000	N = 479
	Between		1.505	0.000	4.000	n = 99
	Within		0.697	-2.272	4.528	T bar = 4.84
LEV	Overall	0.334	0.239	0.000	0.990	N = 482
	Between		0.227	0.012	0.848	n = 99
	Within		0.077	-0.042	1.006	T bar = 4.87
Total Assets	Overall	10440.430	23404.490	81.195	169535.000	N = 482
	Between		23906.160	91.374	151369.800	n = 99
	Within		2897.075	-9054.371	28605.680	T bar = 4.87

3. Conclusion

The findings suggest that compliance with existing board-related corporate governance best practices does not necessarily result in higher stock returns. Particularly, the recommendations relating to the remuneration committee, audit committee, and nomination committee do not appear to significantly impact stock return. A positive effect of compliance with basic board-related best practices was observed probably because minority shareholders in Sri Lanka are concerned only with these best practices. However, the evidence was weak to claim a substantial corporate governance effect on stock return.

This lack of association between compliance with corporate governance best practices and stock returns can be due to three reasons. First, the variation in corporate governance compliance observed among Sri Lankan firms may not be large enough to influence stock return. More precisely, if all the firms are equally-governed despite the slight variations in the compliance indices, a substantial effect of such minor variations cannot be expected on stock return. Second, there can be a possible lack of awareness among Sri Lankan investors on the implications of corporate governance. These investors generally behave like a herd influenced by giant investors without being influenced by the fundamental characteristics of the firms. Similarly, the investors may not have confidence in the roles of various board sub-committees. Therefore, signals of corporate governance compliance become less relevant in investment decisions. Third, as claimed by some literature, owner-managers of firms characterised by concentrated ownership and family ownership in Sri Lanka may be less likely to expropriate owner's wealth through unnecessary perquisites putting the firms'

going-concern at stake. In other words, the conventional corporate governance best practices aimed at firms with dispersed ownership may be relatively ineffective since most Sri Lankan firms are characterised by concentrated or family ownership.

This study does not grossly deny favourable effects of better corporate governance but raises concerns about current corporate governance definitions. More precisely, what constitutes best practices of corporate governance needs to be the subject of a wider debate instead of attempting to measure corporate governance based on the extent of firm's compliance with prevailing best practices. Nevertheless, these claims still need to be validated mainly through survey-based studies. Since the Sri Lankan capital market has remained relatively shallow continuously for an extended period, policy-level initiatives need to be implemented more contextually than globally.

It is, however, noteworthy that this study suffers from two limitations. First, this study controls only for firm size and leverage. However, since there can be many other factors that determine the stock return, future studies also need to control for these other factors. Second, this study considers only 18 best practices when measuring corporate governance. However, an index with border coverage may be necessary to capture the actual effect of corporate governance. Moreover, this study did not attempt to observe the response of stock prices to the release of corporate governance information with the publication of annual reports. This would be an interesting area for future research.

Table 4: Random effects panel regression results

Variable	Model and dependent variable											
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)			
	CGain	CGain	CGain	Div	Div	Div	TSR	TSR	TSR			
BB	0.026 ** (1.962)	0.026 * (1.878)	0.026 ** (2.042)	-0.684 (-0.984)	-0.684 (-0.709)	-0.684 (-0.688)	0.031 ** (2.150)	0.031 ** (1.965)	0.031 (1.551)			
RC	0.006 (0.364)	0.006 (0.363)	0.006 (0.249)	-1.686 * (-1.857)	-1.686 (-1.433)	-1.686 (-1.423)	0.015 (0.851)	0.015 (0.864)	0.015 (0.844)			
AC	0.007 (0.319)	0.007 (0.319)	0.007 (0.288)	1.692 (1.489)	1.692 (1.475)	1.692 (1.344)	0.012 (0.490)	0.012 (0.501)	0.012 (0.497)			
NC	0.001 (0.208)	0.001 (0.222)	0.001 (0.231)	0.540 (1.232)	0.540 (1.052)	0.540 (1.015)	0.002 (0.304)	0.002 (0.337)	0.002 (0.370)			
LEV	-0.041 (-0.915)	-0.041 (-1.008)	-0.041 (-1.026)	6.916 ** (1.989)	6.916 (1.542)	6.916 (1.368)	-0.023 (-0.468)	-0.023 (-0.475)	-0.023 (-0.431)			
2017.Year	0.078 *** (2.675)	0.078 *** (2.566)	0.078 *** (2.650)	2.311 ** (2.104)	2.311 (1.559)	2.311 (1.613)	0.084 *** (2.775)	0.084 *** (2.615)	0.084 ** (2.462)			
2018.Year	0.013 (0.432)	0.013 (0.449)	0.013 (0.65)	0.301 (0.269)	0.301 (0.317)	0.301 (0.326)	0.000 (0.002)	0.000 (0.002)	0.000 (0.002)			
2019.Year	0.060 ** (2.043)	0.060 ** (2.019)	0.060 ** (2.40)	-0.630 (-0.555)	-0.630 (-0.879)	-0.630 (-0.948)	0.048 (1.569)	0.048 (1.591)	0.048 (1.586)			
2020.Year	0.109 *** (3.608)	0.109 *** (3.738)	0.109 *** (3.62)	-1.347 (-1.144)	-1.347 * (-1.866)	-1.347 * (-1.690)	0.094 *** (3.000)	0.094 *** (2.997)	0.094 *** (2.977)			
SIZE	0.011 (0.528)	0.011 (0.501)	0.011 (0.48)	0.591 (0.335)	0.591 (0.344)	0.591 (0.271)	0.013 (0.528)	0.013 (0.497)	0.013 (0.418)			
α	-0.247 ** (-2.135)	-0.247 ** (-2.324)	-0.247 ** (-2.301)	2.930 (0.481)	2.930 (0.569)	2.930 (0.548)	-0.293 ** (-2.351)	-0.293 *** (-2.615)	-0.293 ** (-2.478)			

χ^2 (10)	24.906 ***	25.936 ***	27.098 ***	24.504 ***	15.644	18.814 **	25.434 ***	25.061 ***	23.097 ***
N	474	474	474	461	461	461	458	458	458
R ² Within	0.046	0.046	0.046	0.072	0.072	0.072	0.049	0.049	0.049
R ² Between	0.089	0.089	0.089	0.000	0.000	0.000	0.100	0.100	0.100
R ² Overall	0.052	0.052	0.052	0.008	0.008	0.008	0.054	0.054	0.054

Notes: BB - Basic Board index; RC - Remuneration Committee Index; AC - Audit Committee Index; NC – Nominations Committee Index; LEV - Leverage; SIZE - Firm size (Total Assets); α – constant.
t-statistic is within parentheses; *, **, *** respectively indicate statistical significance at 0.10, 0.05 and 0.01 levels.

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