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Impact of Board Characteristics and Audit Quality on Financial Performance in Sri Lankan Listed Commercial Banks

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Abstract

The study mainly focuses on how better corporate governance affects financial performance and how corporate governance practices affect Sri Lanka's licensed commercial banks. By the board size, Board Independence, CEO Duality, Gender Diversity, Board Composition, and Audit quality, the study defines corporate governance and financial performance considers the dependent variables. This study's objective is to analyze the levels and direct connection between corporate governance and factors and the financial performance of Sri Lankan commercial banks. In order to allow the banking industry in Sri Lanka to establish a strategy for improving corporate governance, the study identifies various factors that are of major importance as regards bank management. This will help the Banks to improve their competitive position in the banking sector and ensure that they can survive, particularly during an era of extreme competition. This study focuses on the sample of 11 banks out of 24 licensed commercial banks and the study collects data over the period from 2018 to 2022. The panel regression analysis was used to analyze the relationship between the variables. The results suggest that the Board size has a significant negative impact to ROE and positively significantly affects to ROA and Board Independence positively and significantly affects ROE.

Keywords: *Commercial Banks, Corporate Governance, Financial performance, Audit Quality*

1. Introduction

1.1. Background of the Study

In the early nineteenth century, before the development of the limited liability company, business was conducted as a sole proprietorship, partnership, or unincorporated organization. If the company collapses, creditors may sue the owners until they become bankrupt. The incorporation of legal entities is regarded as one of the best systems ever devised. Shareholders in a limited liability business are no longer liable for the firm's funds. Ownership, however, remained the foundation of power. The BOD is elected by shareholders, and they are responsible for stewardship and reporting to shareholders. (Tricker, 2011).

The basic principles of Corporate Governance, which are very important in terms of organization growth, efficiency, effectiveness, sustainability, and competitiveness, are broadly accepted throughout the world. The characteristics of a good corporate management system shall therefore include strong organizational ethics, solid policy and practice, and efficient and effective monitoring systems. The board size, percentage of independent directors of the board, gender diversity, number of board meetings held annually, CEO duality, and audit quality are necessary components of CG for successful board performance and prompting sound CG.

The Sri Lankan Institute of Chartered Accountants (ICASL) and the Securities and Exchange Commission's (SEC) code of best practice on CG require Sri Lankan banks to adhere. This demonstrates that regulatory bodies are particularly interested in CG since it is directly related to bank performance. Aspects of CG are important because they promote effective corporate mechanisms, sound decision-making, and investment possibilities with integrity.

1.2. Problem Justification and Problem Statement

1.2.1. Justification of the Research Issue

CG procedures are vital to gaining and sustaining public confidence and faith in the banking system, and hence to ensure a smooth operation of banking and the economy. However, CG in the banking industry has received attention, particularly in developing countries. This study highlights many elements important to CG in the context of COBs in Sri Lanka, allowing the banks to build strategies to strengthen CG. This improves the bank's competitive position in the banking industry and assures the bank's survival, especially in this period of fierce competition.

Even there is a strong regulatory framework exists, it also requires having a strong entity level governance mechanism as well. Considering the Sri Lankan financial history, Pramuka Bank crisis is identified as the first bank collapse in Sri Lanka. The Central Bank made some announcements about the behavior of the bank's management and about its decision to close the bank and divide the available assets of Pramuka among depositors and creditors. It has informed the BOD of Pramuka that insolvency

was caused by ineffective management, risky, inappropriate, and careless practices at the bank by those responsible for the affairs of Pramuka Savings and Development Bank.

According to the findings of (Palanippan , 2016), there is a negative correlation between the firms' performance indicators and the extent of board characteristics. The focus also reveals a manifestly large negative correlation between the size of the board and Tobins Q, ROA, and ROE. The available evidence indicates that the independence of the board and frequency of meetings moderate the connection between finance performance in terms of returns on equity and ROA, by strengthening these elements within CG mechanisms.

By considering all above facts, the primary purpose of this study is to assess the impact of CG factors and characteristics impacting the FP in terms of Sri Lankan banking sector due to having a dearth of previous studies in Sri Lankan context. Accordingly, the secondary objective of this study is to contribute to the existing literature by identifying the impact of CG on determining FP in terms of ROA and ROE.

1.2.2. Problem Statement

Based on the above justification, the problem statement for the study is, “What is the impact of CG practices on the firm FP of licensed COBs in Sri Lanka.”

1.3. Research Questions and Objectives

1.3.1. Research Questions

Based on the previously covered research issue, the study’s Objectives can be stated as follows,

1. What is the level of existing CG systems in place at Sri Lanka’s COB?
2. What is the level of perceived performance?
3. How do CG practices and firm FP relate to one another?

1.3.2. Research Objectives

The two key objectives of this study are based on the above-mentioned research questions and key objectives as follows,

1. To assess the level of existing CG practices and mechanisms of COBs in Sri Lanka.
2. To examine the relationship between CG practices and organizational FP.

2. Literature Review

2.1. Corporate Governance

A Cadbury report was published in 1992 which set out several recommendations relating to CG. (Cadbury Report, 1992) Defines CG as the system in which companies are managed and controlled. BOD plays a significant role in the governance of companies. Shareholders have the responsibility of appointing directors and auditors and ensuring that an effective governance structure is in place. The Board's main responsibilities shall be to set the strategic objectives of the enterprise, ensure that leadership is in place enabling it to take effect, manage its operations and report on their management to shareholders. Law, regulation, and the shareholders' general meeting shall govern the work of the Board.

In 1999, the OECD Principles on CG came into force. The principles aim at providing guidance for governments on how to improve the legislative, institutional, and Regulatory Framework underpinning CG (OECD, 1999). It shows that the separation of powers between the management, the BOD, and the majority and minority shareholders is largely the basis for effective CG. In addition to providing standards and recommendations for the stock exchange, investors, corporations, and other parties who play a significant role in promoting better CG, the OECD's principles of CG support member and non-member governments in their efforts to assess and enhance the legal, institutional, and regulatory framework for CG in their nations. For banks operating on a global level, these CG standards and structures are particularly important. For that purpose, the principle of the OECD may serve as a model for governance structures in multinational financial institutions.

The BOD has the responsibility of ensuring that the information provided by the company is accurate. An adequate number of independent directors who are executives of the company should also be appointed to the board.

A further review of the OECD principles on CG has been carried out by the OECD Corporate Governance Committee. 2014, the review process was initiated and concluded in 2015. This review has been justified, as it ensures that the Principles remain of high quality, relevance and usefulness in view of current developments in the corporate sector and capital markets.The outcome is a sound benchmark for the establishment of an effective CG framework, which will allow policymakers, regulators, and other regulatory bodies to carry out their tasks effectively. The new principles were revised to six principles and those principles explain establishing the foundation for a system for efficient CG, the rights of shareholders and essential aspects of ownership, the fair handling of shareholders, stakeholders' involvement in CG, disclosure, and openness, and the board's duties.

The revision of these principles clearly underlines the importance of a regulatory framework for CG, which is designed to promote market efficiency and facilitate effective enforcement with clear responsibility among all supervisors, regulators, and enforcement authorities.

2.2. Corporate Governance for Licensed Commercial Banks in Sri Lanka

The Monetary Board shall issue instructions for improving and maintaining the CG of licensed COB in Sri Lanka under paragraph 46(1) of the Banking Act No 30 of 1988, with a view to enhancing the stability of the overall banking sector. Several principles have been set out and applied in the context of CG. (Central Bank of Sri Lanka, 2013) Those are the responsibilities of the board, the Board's composition, criteria to assess the fitness and propriety of directors, criteria to assess the fitness and propriety of Directors, management functions delegated by the Board, the Chairman and the Chief Executive Officer, board-appointed committees, related party transactions, and Disclosures.

2.3. Theoretical Perspectives

CG theory considers the board of directors as a mechanism for reducing problems arising from extensive separation of ownership and control. The Agency Theory observes that a modern company is highly separated from its owners and management, resulting in conflicts of interest between the owners and their agents. Resource dependency theory is considered directors as boundary-spanning network nodes that can link the business to its strategic environment. This viewpoint studies the interconnectedness of organizations in a market and can help to eliminate ambiguity in corporate choices (Tricker, 2011).

(Jensen & Meckling , 1976) interpret the agency theory in their research study. They define agency as activities of one or more individuals (BOD) carrying out on behalf of someone else (Shareholders). This relationship leads to an agency problem when both parties try to maximize their interest. (Alhassan, Zyambo, & Boakye, 2012) provide support for both agency and resource dependency theory. Studies suggest that having large board and well-functioning audit committees positively impact FP. Furthermore, the study discloses that NEDs play a crucial role in addressing agency conflicts. (Assenga, Aly, & Hussainey, 2018) In the context of agency theory, this theory supports the seperation of chairman and CEO. Findings of this research do not provide support the link between outside directors and FP. In relation to resource dependency theory, the study reveals the gender diversity of the board has a positive impact on FP.

The managerial and class hegemony viewpoint on CG focuses on how directors see themselves, how it affects their conduct, and what it means for CG. In certain businesses, directors saw themselves as an elite club. They are compelled by their view of themselves as elite to dominate the internal structure of the business and its exterior relationships. Appointing top management ensures that newcomers blend into the elite and preserve their reputation. Similar to this, new independent directors will probably only be proposed for and selected provided they continue the governing group's control. Class hegemony acknowledges that board conduct and performance may be impacted by directors' self-perceptions.

Additionally, executive directors may control board choices due to their access to information, familiarity with current operations, and ability to make judgments. (Tricker, 2011).

(Donaldson & Preston, 1995) have argued that the stakeholder theory is a "managerial" concept, and therefore recommend attitudes, structures, and procedures which are taken together to form an enterprise management philosophy. The theory goes beyond a purely descriptive assessment that "organizations have shareholders" which, although true, has no direct management implications.

2.4. Relationship of Better Corporate Governance to Firm Financial Performance

Hakimi, et al., (2018) indicate a positive and statistically significant correlation between board duality and bank performance as measured by both ROA and ROE. In addition to that they have found the board size has a positive and significant impact only when the profitability is measured by ROE. Having considered on another study, (Grove, et al., 2011) state CEO duality is negatively associated with FP, indicating that having the same individual for both chairman and chief executive officer positions of the board leads adverse impact on the firm performance. Based on the analysis done (Nas & Kalaycioglu, 2016) considering 221 exporting firms for four years, findings reveal about board composition and its impact on export performance. There was a systematic positive correlation between board size and all measures of export performance. Contrarily higher proportion of outside directors on the board has shown a negative impact on export performance. Furthermore, the separation of the chariman and CEO has a positive impact on export performance. This implies that having two separate individuals for these two positions enables the firm to achieve favourable outcomes. By analyzing CG structures of 391 Indian companies out of 500 companies listed on the national stock exchange over five financial years, (Mishra & Kapil, 2018) suggest that the CG impact more on the market base measurements compared to accounting-based measure. Further they have indicated that there is a significant positive relationship between board size, board independence, number of board meetings, and firm performance. Moreover, the study reveals that the separation of the chief executive officer and the chairman of the board is creating value for the firm. On the other hand, study reveals that overburdened directors hurt firm performance. Another research study (Abang'a, et al., 2022) discloses that board meetings, board skill, and gender diversity show a significant and positive association with capital budget realization ratio (CBRR) by analyzing a sample of 45 state-owned enterprises (SOEs) in Kenya. Moreover, this study implies that the aggregate CG disclosure index, the presence of board sub-committees, board size, and the inclusion of independent NED are positively related to CBRR. However, these relationships are not statistically significant. (Varghese & Sasidharan, 2019) Attempt to investigate the effect of ownership structure and board characteristics on business value in both Indian and China economies. In China, the dual nature of the CEO increases the value of the company, but the results are not positive for Indian companies. In addition, companies in China are negatively affected by board independence as it is positively correlated with company value in India. In the end, the study has shown that increased board size is beneficial to more appropriate decision-making.

2.5. Research Gap

By considering all these prior studies, most of the results show that there is a positive, favourable impact on the outcomes and FP of the organizations. Upon reviewing existing research, it indicates that there is a lack of studies exploring the relationship between CG practices and the FP of COBs within the local context. Identifying this research gap, this study aims to address this by focusing on COBs in Sri Lanka. By undertaking this research, the study aims to contribute valuable insights to the existing literature on this subject matter.

3. Research Methodology

3.1. Research Approach

The positive paradigm is a way of measuring reality in terms of independent components. Additionally, it was shown that the procedures utilized in the positivistic paradigm included hypothesis verification, quantitative approaches, surveys, and experiments (Guba & Lincoln 1994). Coghlan and Brydon-Miller (2014) state that the positivist approach is a widely used method in the social sciences where the goal is to gather numerical data to more accurately analyse the data. argue that the positivist approach is a well-known strategy employed in the social sciences where the objective is to obtain numerical data with the purpose of more reliably analysing the data.

3.2. Research Method

Many more studies were conducted in the quantitative method to support the objectives of the respective research, as referred to by the related prior work carried out for this study.

Furthermore, it has been noted that this current research study also focuses on defining levels of governance factors, (bank board characteristics and audit quality) and the FP of the banks to achieve its established objectives. This study should also be implemented quantitatively, taking into consideration both the nature of objectives as well as expected results.

3.3. Population and Study Sample

The population is extracted from the licensed COB registered at the Central Bank of Sri Lanka. The registered list includes 24 licensed COBs, out of that population, those which have not been listed under the CSE and annual reports are not published properly and the banks and non-banking financial companies and financial institutions which are having their financial accounting periods as of 31st March have been excluded.

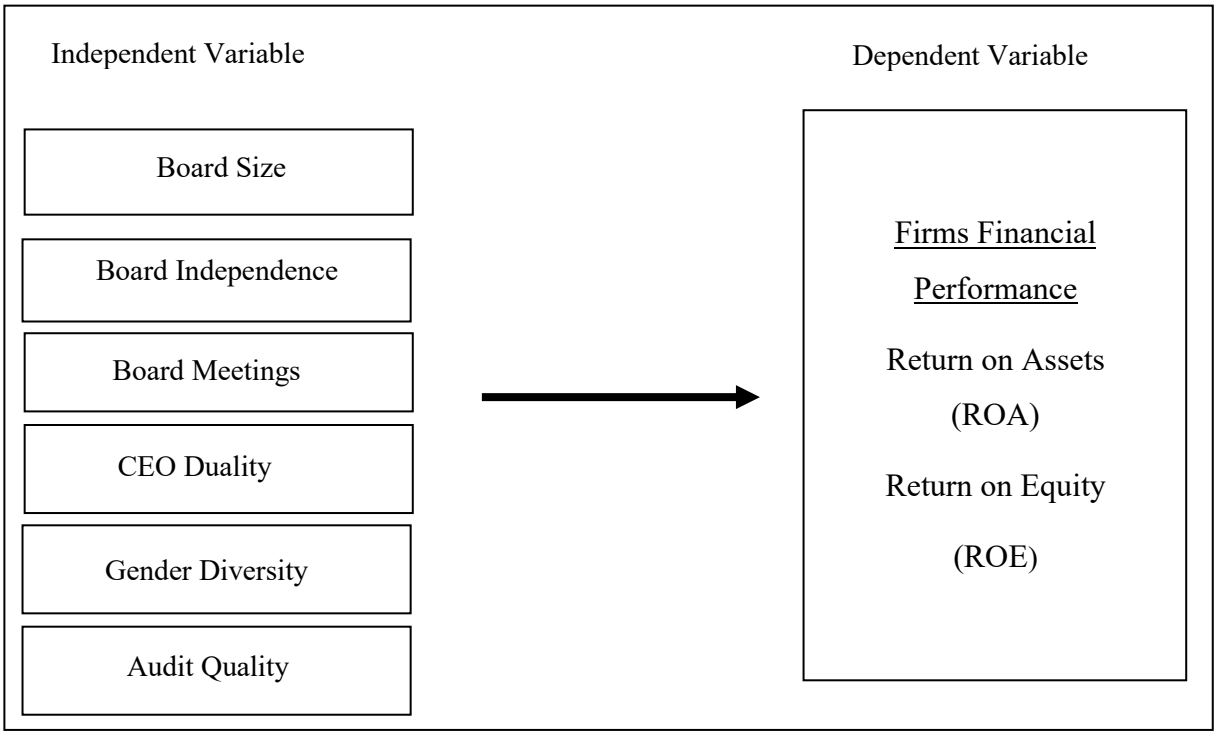
3.4. Sample Size and Selection of Sample

From the licensed COBs in Sri Lanka which are listed in the CSE, the sample will be selected. There are 24 licensed COBs under the supervision of the central bank of Sri Lanka. The sample consists of 11 COBs, including Bank of Ceylon, Commercial bank of Ceylon PLC, DFCC Bank PLC, Hatton National Bank PLC, Sampath Bank PLC, Amana Bank PLC, Seylan Bank PLC, National Development Bank PLC, Nations Trust Bank PLC, Pan-Asia-Banking Corporation PLC and Union Bank of Colombo PLC.

3.5. Conceptual Diagram

Figure 1 shows the conceptual framework which has been initiated based on the previous studies (Palanippan, 2016) where the CG factors are considered as the main independent variable and the FP is considered as the dependent variable.

Figure 1- Conceptual Framework



Source: *Author Compiled*

3.6. Hypotheses

Based on the conceptual framework shown in the conceptual diagram section and by referring to the prior literature (Palanippan, 2016) the following hypotheses are developed.

Hypothesis H1: There is a significant impact of board size on the Sri Lankan commercial banks' financial performance.

Hypothesis H2: There is a significant impact of the number of independent directors of the board on the Sri Lankan commercial banks' return on assets.

Hypothesis H3: There is a significant impact of the number of independent directors on the board on the Sri Lankan commercial banks' return on equity.

Hypothesis H4: There is a significant impact of the board meetings on the Sri Lankan commercial banks' financial performance.

Hypothesis H5: There is a significant impact of the CEO duality on the Sri Lankan commercial banks' ROE.

Hypothesis H6: There is a significant impact of Gender diversity within the boards on the financial performance of Sri Lankan Commercial Banks.

Hypothesis H7: There is a significant impact of audit quality on the Sri Lankan commercial banks' return on equity.

3.7. Operationalization

Table 1- Operationalization

Variable	***Definition***	***Measurement***	***Related Studies***
Dependent Variable			
FP	PBDIT/Total assets PBDIT/Paid-up equity capital + reserves funds	ROA (ROA) ROE (ROE)	(Palanippan, 2016)
Independent Variable			
Board Size (BS)	Number of directors on the board.	Number of directors on the board for the entity *I* period *t.*	(Fernando, et al., 2019)
Board Independence (BI)	Number of non-executive independent directors on the board	Number of non-executive independent directors on the board for the entity *I* period *t*.	(Palanippan , 2016)
Board Meetings (BM)	A number of annual meetings of the board.	Several board meetings were held during the year for the entity *I* period *t.*	(Palanippan, 2016)

CEO Duality (CEODUAL)	CEO duality is the circumstance in which one individual occupies the roles of chairman and CEO in the same organization.	1= if the CEO and Chairperson are held by the same person, 0= if not for the entity I period t.	(Palanippan, 2016)
Gender Diversity (GD)	percentage of females on a company's BOD out of all members.	percentage of females on a company's BOD out of all members.	(Danquah, et al., 2022)
Audit Quality (AQ)	Banks who were audited by one of the Big 4 Public Accounting Firms will receive a value of 1, while those who were audited by another firm will receive a value of 0.	Banks who were audited by one of the Big 4 Public Accounting Firms will receive a value of 1, while those who were audited by another firm will receive a value of 0.	(Mahrani & Soewarno, 2018)

Source: Author Compiled

3.8. Sources and Collection of Data

Data is collected from annual reports published on the CSE official website and official websites of the COBs in Sri Lanka for five years covering 2018, 2019, 2020, 2021, and 2022.

3.9. Data Analysis Strategies

Data for the study is collected from the annual reports of the COBs are going to be analyzed under the data analytic soft wares, Stata 15 for descriptive statistics analysis.

Panel regression analysis is appropriate to estimate the relationship between a dependent variable and a set of independent variables. To detect multiple regressions, the following model has been developed. It is expected to determine the relationship between the dependent variable (ROA and ROE) and independent variables (Board characteristics and audit quality) using this multivariate regression analysis.

The panel data regression analysis along with the Hausman test is needed to be done in order to verify the relationship between independent variables and dependent variables with the usage of Stata-15 data

analytic application. Given the nature of the study involving panel data series, it is mostly recommended to use the panel data regression analysis over normal regression analysis for comprehensive analysis.

$$\mathbf{ROA = a + b_1BS + b_2BI + b_3BM + b_4CEODUAL + b_5GD + b_6AQ + e}$$

$$\mathbf{ROE = a + b_1BS + b_2BI + b_3BM + b_4CEODUAL + b_5GD + b_6AQ + e}$$

The key indicators of a company's performance are ROA and ROE, as well as the parameters for explainable variables, are b1, b2, b3, b4, b5, and b6. A is the constant number in this formula, and e is the standard error.

4. Data Analysis

4.1. Reliability Analysis

This study used the scale reliability coefficient to show how reliable the data set was and the average interitem covariance value to find out how closely each item in the data set was linked to the others. Cronbach's alpha is a measure of the scale reliability coefficient as shown in the below table. When the Cronbach alpha value is equal to or greater than 0.7 and the average interitem covariance value is smaller, the data set is more reliable. Based on the table below, a Cronbach alpha value greater than 0.7 (in particular 0.7047) indicates a higher level of reliability for the data set, implying that the data set reflects internal consistency. The comparatively low average interitem correlation (0.1569102) implies that the items in the data set are not strongly connected. This illustrates a diversity among the items, which can be seen as a positive characteristic. Therefore, the researcher can conclude that the scale exhibits acceptable reliability, and the items have a modest level of correlation with one another.

Table 2- Summary of reliability test results

Average interitem covariance	**.**1569102
Scale reliability coefficient	0.7047
Number of items in the scale	8

Source: Author Compiled

4.2. Descriptive Analysis

The ROA value of 6.972% indicates the average return for the total assets during the period of 2018 to 2022 generated by PLC banks in Sri Lanka, with a considerable variability around this mean as indicated by the standard deviation of 4.675. the average ROE of 3.291% indicates that the PLC banks are producing a strong return on their shareholders' equity investments. The significant standard deviation

of 2.253, on the other hand, indicates a significant heterogeneity in ROE values, showing a broad range of performance results among the PLC banks in Sri Lanka. The natural logarithm of board size (ln_BS) has an average value is 2.309, and the data exhibit relatively low variability with a standard deviation of 0.261. The natural logarithm of the board independence (ln_BI) and board meeting (ln_BM) have mean values of 1.863 and 2.612, with lower levels of standard deviations of 0.241 and 0.111, respectively. The average CD value is 0.182, indicating that CEO duality is not commonly observed in the dataset. The standard deviation of 0.389 implies a certain degree of variability in the CEO duality status among the observations, with values spanning from 0 to 1. The existence of variability indicates the few banks where the positions of chairman and CEO are held by the same individual (CD=1) and banks where these positions are held by separate individuals (CD=0). The mean value of AQ is 0.636, suggesting that, on average, there is a significant presence of banks audited by one of the Big 4 Public Accounting Firms in the dataset. The standard deviation of 0.485 indicates variability in audit quality across observations, with a range of 0 to 1. The presence of variability implies that there is a mix of banks audited by the Big 4 (AQ=1) and those audited by other firms (AQ=0) in the dataset. The mean GD value is 14.94, suggesting that the average proportion of females on the boards of directors in the observed companies is roughly 14.94%. The standard deviation of 9.717 indicates a certain degree of heterogeneity in gender diversity among the observations, with values ranging from 0% to 40%. The standard deviation measures the degree to which the percentages of gender diversity differ from the average, emphasizing the spread in gender representation on boards. A higher standard deviation signifies increased variety in gender diversity percentages across the companies in the sample.

Table 3- Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
ROA	55	6.972	4.675	.46	14.2
ROE	55	3.291	2.253	-5.96	7.01
ln BS	55	2.309	.261	1.386	2.639
ln BI	55	1.863	.241	1.099	2.303
ln BM	55	2.612	.111	2.303	2.773
CD	55	.182	.389	0	1
GD	55	14.94	9.717	0	40
AQ	55	.636	.485	0	1

Source: Author Compiled

4.3. Correlation Analysis

The correlation coefficient, ranging from -1 to 1, quantifies both the strength and the direction of the relationship between the variables. Closer to 0 values signify a weak link, whereas positive values denote a direct association, and negative values denote the reverse.

The correlation coefficients indicate a strong positive association between ROA and ln_BS (0.238), as well as ln_BM (0.319). The ROA exhibits a negative correlation with the CD, GD, and AQ. The relationship between ROE and ln_BI is negative, with a correlation coefficient of -0.101. Similarly, there is a negative relationship between ROE and ln_BM, with a correlation coefficient of -0.153. The variable ln_BS exhibits a strong positive association with ln_BI (0.847), ln_BM (0.290), GD (0.344), and AQ (0.361), whereas it demonstrates a negative link with CD (-0.221). The variable ln_BI demonstrates a significant positive association with ln_BS (0.847) but displays lesser connections with ln_BM (0.148), CD (-0.370), GD (0.368), and AQ (0.333). The variable ln_BM exhibits a positive correlation with ln_BS (0.290) and a negative correlation with CD (-0.083). The correlation coefficient between it and ROE is -0.153, indicating a negative association. There exist moderate positive relationships between GD and ln_BS (0.344), ln_BI (0.368), and AQ (0.115). There exists a lower negative association between it and ROA, with a correlation coefficient of -0.089. There exists a direct relationship between AQ and ln_BS (0.361), ln_BI (0.333), and GD (0.115). ROA and ln_BM have negative relationships, with coefficients of -0.212 and -0.144, respectively.

Table 4 - Pairwise correlations

Variables	**(1)**	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**	**(7)**	**(8)**
(1) ROA	1.000							
(2) ROE	-0.163	1.000						
(3) ln_BS	0.238	-0.301	1.000					
(4) ln_BI	0.110	-0.101	0.847	1.000				
(5) ln_BM	0.319	-0.153	0.290	0.148	1.000			
(6) CD	0.277	0.005	-0.221	-0.370	-0.083	1.000		
(7) GD	-0.089	0.129	0.344	0.368	0.140	-0.166	1.000	
(8) AQ	-0.212	-0.081	0.361	0.333	-0.144	-0.134	0.115	1.000

Source: Author Compiled

4.4. Hausman Test

According to this test, the researcher could develop the following hypotheses.

H0: Random effect model is preferred.

H1: Fixed effect model is preferred.

4.4.1. Hausman test for ROA

The results of the Hausman (1978) specification test show a chi-square test value of 10.563 with a corresponding p-value of 0.032. The low p-value of 0.032 suggests that the researcher would reject the null hypothesis at the conventional significance level of 0.05. This implies that there is evidence to suggest a systematic difference between the coefficients obtained from the random effects and fixed effects models. Hence, the FE model is preferred for regression analysis.

Table 5- Hausman (1978) specification test for Model 1

	Coef.
Chi-square test value	10.563
P-value	.032

Source: Author Compiled

4.5. Hausman Test

4.5.1. Hausman Test for ROE

The Hausman (1978) specification test in this scenario produces a chi-square test statistic of 0.33, accompanied by a p-value of 0.988. Considering a p-value of 0.988, significantly greater than the standard significance level of 0.05, a researcher would not reject the null hypothesis. There is insufficient evidence to establish a consistent difference between the coefficients obtained from the random effects and fixed effects models. In short, the random effects model is seen as more reliable and effective when compared to the fixed effects model.

Table 6 - Hausman (1978) specification test for Model 2

	Coef.
Chi-square test value	.33
P-value	.988

Source: Author Compiled

4.6. Normality Test

The Shapiro-Wilk test is a statistical technique used to ascertain if a particular dataset follows a normal distribution. The study analyzed the residuals of the regression model. The researcher might suggest the following hypotheses to evaluate the normality of the dataset;

H0: Data set follows a normal distribution.

H1: Data set does not follow a normal distribution.

If the p-value is smaller than the predefined significance level (often 0.05), a researcher would reject the null hypothesis of normality. If the p-value exceeds the significance level, a researcher would not reject the null hypothesis, indicating a lack of substantial evidence to support the claim that the data deviates from a normal distribution.

4.6.1. Normality Test for Model 1

According to the table below, the p-value of 0.018 is less than 0.05, indicating that a researcher would reject the null hypothesis of normality. Therefore, based on the Shapiro-Wilk test, there is evidence to suggest that the data may not follow a normal distribution. The researcher has two alternatives to conducting panel regression analysis: either using the fixed effects (FE) model, which does not require the assumption of normality, or using robust regression. Due to the Hausman test indicating greater consistency, the researcher could perform panel regression using the FE model. Hence, the researcher can use the FE model to mitigate the presence of non-normality.

Table 7 - Shapiro-Wilk W test for Model 1

Variable	Obs	W	V	z	Prob>z
residuals	55	0.948	2.661	2.099	0.018

Source: Author Compiled

4.6.2. Normality Test for Model 2

According to the table below, the p-value of 0.548 is less than 0.05, indicating that a researcher does not have enough evidence to reject the null hypothesis of normality. Therefore, based on the Shapiro-Wilk test, there is evidence to suggest that the data may follow a normal distribution. Hence, the researcher could proceed the panel regression analysis with RE model.

Table 8- Shapiro-Wilk W test for model 2

Variable	Obs	W	V	z	Prob>z
residuals1	55	0.981	0.946	-0.119	0.548

Source: Author Compiled

4.7. Heteroskedasticity Test

The researcher can formulate the following hypotheses to evaluate the presence of heteroscedasticity in the dataset:

H0: There is homoscedasticity.

H1: There is heteroscedasticity.

4.7.1. Heteroskedasticity Test for Model 1

The White's test results in a chi-squared test statistic of 34.10 and 25 degrees of freedom, leading to a p-value of 0.1057. The outcome does not support the rejection of the null hypothesis of homoskedasticity, indicating that there is not enough evidence to assert unrestricted heteroskedasticity. The decomposition conducted by Cameron & Trivedi reveals that heteroskedasticity is associated with a chi-squared value of 34.100, 25 degrees of freedom, and a p-value of 0.106. The collective evidence from both tests strengthens the conclusion that there is no statistically significant evidence of unconstrained heteroskedasticity in the data, as the p-values surpass the standard significance level of 0.05.

White’s test for Ho: homoskedasticity
against Ha: unrestricted heteroskedasticity
chi2(25) = 34.10
Prob > chi2 = 0.1057

Table 9 - Cameron & Trivedi's decomposition of IM-test for model 1

Source	chi2	df	p
Heteroskedasticity	34.100	25	0.106
Skewness	13.610	6	0.034
Kurtosis	2.640	1	0.104
Total	50.360	32	0.021

Source: Author Compiled

4.7.2. Heteroskedasticity Test for Model 2

The White's test produces a chi-squared test statistic of 18.93 with 25 degrees of freedom and a p-value of 0.8006, suggesting that there is no statistical significance. This finding corroborates the notion that the errors' variance remains consistent across all observations. The decomposition conducted by Cameron & Trivedi provides a detailed breakdown of the chi-squared contributions, highlighting that the sole source of heteroskedasticity produces a chi-squared value of 18.930 with 25 degrees of freedom

and a p-value of 0.801. The cumulative evidence from both tests, with a chi-squared value of 29.710 and 32 degrees of freedom, strengthens the conclusion that there is no substantial evidence of unrestricted heteroskedasticity in the data, as the p-values significantly above the conventional 0.05 significance level.

White's test for Ho: homoskedasticity
against Ha: unrestricted heteroskedasticity
chi2(25) = 18.93
Prob > chi2 = 0.8006

Table 10- Cameron & Trivedi's decomposition of IM-test for model 2

Source	chi2	df	p
Heteroskedasticity	18.930	25	0.801
Skewness	8.480	6	0.205
Kurtosis	2.300	1	0.129
Total	29.710	32	0.583

Source: Author Compiled

4.8. Autocorrelation Test

The researcher can formulate the following hypotheses to evaluate the presence of autocorrelation in the dataset:

H0: There is no autocorrelation among the error terms.

H1: There is autocorrelation among the error terms

4.8.1. Autocorrelation Test for Model 1

The test produced a test statistic (F) of 0.057 with degrees of freedom (1, 10) and a p-value of 0.8166. The higher p-value signifies insufficient statistical evidence to reject the null hypothesis, implying the absence of significant first-order autocorrelation in the error terms of the panel data regression model. Therefore, based on these results, it is reasonable to assume that there is no autocorrelation. This means that the estimated coefficients in the model are not affected by any bias caused by first-order autocorrelation.

Wooldridge test for autocorrelation in panel data
H0: no first-order autocorrelation

F(1, 10) = 0.057
Prob > F = 0.8166

Table 11- Autocorrelation test for model 1

F (1, 10)	0.057
Prob > F	0.8166

Source: Author Compiled

4.8.2. Autocorrelation Test for Model 2

The test produced a test statistic (F) of 4.556 with degrees of freedom (1, 10), and the corresponding p-value is 0.0586. Although the test statistic surpasses the crucial threshold, the p-value is somewhat greater than the traditional significance criteria of 0.05. Therefore, the findings indicate a situation that is on the edge, prompting one to approach it with a critical understanding. Although there is a slight indication of possible first-order autocorrelation, it does not meet the standard threshold for statistical significance. Hence, the researcher could conclude that there is no autocorrelation among the error terms.

Wooldridge test for autocorrelation in panel data

H0: no first-order autocorrelation

F(1, 10) = 4.556

Prob > F = 0.0586

Table 12- Autocorrelation test for model 2

F(1, 10)	4.556
Prob > F	0.0586

Source: Author Compiled

4.9. Multicollinearity Test

According to the table below, VIF values for all the independent variables are less than 10, suggesting a mean VIF of 2.267. As per the decision criteria stated before, VIF values are in the acceptable range indicating there is a lower-level risk of multicollinearity. Therefore, the researcher could proceed with the multiple regression analysis to test the hypotheses.

Table 13- Variance inflation factor

	VIF	1/VIF
ln BS	4.382	.228
ln BI	4.327	.231
AQ	1.253	.798
ln BM	1.246	.802
CD	1.221	.819
GD	1.17	.854
Mean VIF	2.267	.

Source: Author Compiled

4.10. Panel Regression Analysis

In this study, the researcher utilized panel regression to analyze the data collected from 11 publicly listed banks in CSE over the period of 2018 to 2022. Two models were used for the regression analysis. In model 1, the dependent variable was ROA, while in model 2, the dependent variable was ROE. All the independent variables are included in both models, with some variables being in natural logarithm form, such as board size, board independence, and board meeting. As previously discussed, a Hausman specification test was conducted for both models to determine the preferred model for running regression analysis. This test helps to determine whether the random effects (RE) model or the fixed effects (FE) model is more appropriate.

4.10.1. Regression Analysis for ROA

Based on the Hausman test, the FE model is applied to conduct a panel regression for model 1. This model examines the relationship between the dependent variable, ROA, and several independent variables (ln_BS, ln_BI, ln_BM, GD). However, two dummy variables, CD and AQ, are excluded from the analysis due to perfect collinearity. The normality test showed the non-normal of the data set, which needed to run the panel regression with the FE model to avoid non-normality issues.

According to the table below, overall model significance is tested by Prob>F, which is 0.103, suggesting that the overall model is not significant at the 5% level since the p-value is more than 0.05. Although the Prob>F value is slightly above 0.1, it is not statistically significant at the 10% level. However, it is close to that threshold. Overall R squared (0.134) indicates that approximately 13.4% of the changes in ROA are explained by the ln_BS, ln_BI, ln_BM, and GD.

When examining the coefficient values in the table, ln_BS is 7.229 with a p-value of 0.037, implying that a director added to the board, ROA is estimated to increase by 7.229% while all the other independent variables are held in constant. Moreover, the below table suggests independent variables

which are ln_BI, ln_BM, and GD do not show statistical significance with the dependent variable (ROA) since their respective t values (-1.45, 0.50, and 0.71) are less than 2 and p values (0.179, 0.631, and 0.492) are more than 0.05. Because the P-value (0.037) is less than 0.05 and the T-value (2.40) is larger than 2, the ln_BS has a statistically significant relationship with the ROA of publicly listed commercial banks in Sri Lanka. The constant coefficient value indicates that the absence of directors on the board leads to a decrease of 6.787% in ROA.

Table 14- Regression results for model 1

ROA	Coef.	St.Err.	t-value	p-value	[95% Conf	Interval]	Sig
ln_BS	7.229	3.008	2.40	.037	.528	13.931	**
ln_BI	-2.843	1.967	-1.45	.179	-7.225	1.54	
ln_BM	.795	1.605	0.50	.631	-2.78	4.371	
o	0	.	.	.	.	.	
GD	.019	.026	0.71	.492	-.04	.077	
o	0	.	.	.	.	.	
Constant	-6.787	9.055	-0.75	.471	-26.963	13.389	

Mean dependent var	6.972	SD dependent var	4.675
R-squared	0.134	Number of obs	55
F-test	2.683	Prob > F	0.103
Akaike crit. (AIC)	148.978	Bayesian crit. (BIC)	157.007

*** *p<.01, ** p<.05, * p<.1*

Source: Author Compiled

Based on the results of panel regression analysis, the researcher might develop the following regression equation.

Y =-6.787 + 7.229(X1) - 2.843(X2) + 0.795(X3) + 0.019(X4)

Y = Return on Assets (ROA)

X1= Logarithm of Board Size (ln_BS)

X2= Logarithm of Board Independence (ln_BI)

X3= Logarithm of Board Meetings (ln_BM)

X4= Gender Diversity (GD)

4.10.2. Regression Analysis for ROE

Based on the Hausman test, the RE model is applied to conduct a panel regression for model 2. This model examines the relationship between the dependent variable, ROE, and several independent variables (ln_BS, ln_BI, ln_BM, CD, GD, and AQ). The RE model can be applied without any issues as the dataset satisfies all the assumptions that were tested, including normality, heteroskedasticity, and autocorrelation.

According to the table below, overall model significance is tested by Prob>chi2, which is 0.036, suggesting that the overall model is significant at the 5% level since the p-value is less than 0.05. Overall R squared (0.220) indicates that approximately 22% of the changes in ROA are explained by the ln_BS, ln_BI, ln_BM, CD, AQ, and GD.

When examining the coefficient values in the table, ln_BS is -6.882 with a p-value of 0.003, implying that a director added to the board, ROE is estimated to decrease by 6.882% while all the other independent variables are held in constant. Similarly, ln_BI has a coefficient value of 4.761 with a p-value of 0.055, revealing that if an independent non-executive director were added to the board, it would result in increased ROE by 4.761%. Moreover, the below table suggests independent variables which are ln_BM, CD, GD, and AQ do not show statistical significance with the dependent variable (ROE) since their respective t values (-0.16, 0.39, 1.64, and 0.11) are less than 2 and p values (0.876, 0.694, 0.102, and 0.916) are more than 0.05. Because the P-value (0.003) is less than 0.01 and the T-value (2.98) is larger than 2, the ln_BS has a statistically significant relationship with the ROE of publicly listed commercial banks in Sri Lanka. Moreover, the t-value of 1.92 for ln_BI is slightly below 2, but the p-value of 0.055 suggests a noteworthy relationship between ln_BI and ROE. Based on the analysis conducted, it is evident that the presence or absence of certain directors on the board has a significant impact on the return on equity (ROE). Specifically, the coefficient value of constant term suggests that the absence of directors and independent non-executive directors on the board results in a notable increase of 10.61% in ROE.

Table 15- Regression results for model 2

ROE	Coef.	St.Err.	t-value	p-value	[95% Conf	Interval]	Sig
ln_BS	-6.882	2.307	-2.98	.003	-11.404	-2.36	***
ln_BI	4.761	2.482	1.92	.055	-.103	9.624	*
ln_BM	-.451	2.897	-0.16	.876	-6.129	5.226	
CD	.321	.816	0.39	.694	-1.278	1.919	
GD	.052	.032	1.64	.102	-.01	.115	
AQ	.07	.663	0.11	.916	-1.229	1.369	
Constant	10.61	7.275	1.46	.145	-3.648	24.868	

Mean dependent var	3.291	SD dependent var	2.253
Overall r-squared	0.220	Number of obs	55
Chi-square	13.499	Prob > chi2	0.036
R-squared within	0.013	R-squared between	0.765

**** p<.01, ** p<.05, * p<.1*

Source: Author Compiled

Based on the results of panel regression analysis, the researcher might develop the following regression equation;

Y = 10.61 – 6.882 (X1) + 4.761 (X2) – 0.451(X3) + 0.321(X4) + 0.052(X5) + 0.07(X6)

Y = Return on Equity (ROE)

X1= Logarithm of Board Size (ln_BS)

X2= Logarithm of Board Independence (ln_BI)

X3= Logarithm of Board Meetings (ln_BM)

X4= CEO Duality (CD)

X5= Gender Diversity (GD)

X6= Audit Quality (AQ)

4.11. Hypotheses Testing

Hypothesis H1*: There is a significant impact of board size on the Sri Lankan commercial banks' financial performance.*

In this study, the researcher used both the measurements of ROA and ROE to assess the financial performance of publicly listed commercial banks in Sri Lanka. According to the table below, both models suggest that Board Size has a statistically significant impact on the ROA and ROE since their respective t-values (2.40 and -2.98) are more than 2 and p-values (0.037 and 0.003) are less than 0.01. Therefore, the researcher has enough evidence to reject the null hypothesis which states that there is no significant impact of board size on the Sri Lankan commercial banks' financial performance. This result is consistent with previous studies conducted by Ghazali (2020) and Palaniappan (2017), which demonstrated that the size of the board of directors has a significant impact on the performance of the company. In addition, Ghazali (2020) suggests that a larger board size facilitates the inclusion of a wide range of viewpoints, talents, and experiences, which as a result improves the quality of decision-making. According to Palaniappan (2017), there is a negative relationship between the size of the board and the performance of the firm. This implies that as the board size increases, the financial performance of the company tends to decline.

Hypothesis H2*: There is a significant impact of the number of independent directors of the board on the Sri Lankan commercial banks' return on assets.*

Based on the findings from Model 1 in the table below, it appears that Board Independence does not have a significant effect on the ROA of publicly listed commercial banks in Sri Lanka. The result is supported by the t-value of -1.45, below the threshold of 2, and the p-value of 0.179, which exceeds the significance level of 0.05. Thus, the researcher lacks sufficient evidence to reject the null hypothesis, which suggests that there is no significant impact of board independence on the return on assets of Sri Lankan commercial banks.

Hypothesis H3*: There is a significant impact of the number of independent directors on the board on the Sri Lankan commercial banks' return on equity.*

Based on the findings from Model 2 in the table below, it appears that Board Independence does not have a significant effect on the ROE of publicly listed commercial banks in Sri Lanka. The result is supported by the t-value of 1.92, slightly below the threshold of 2, and the p-value of 0.055, which slightly exceeds the significance level of 0.05, but is below the 0.1 significance level. Thus, the researcher has sufficient evidence to reject the null hypothesis, which suggests that there is no significant impact of board independence on the return on equity of Sri Lankan commercial banks.

Palaniappan's (2017) study provides evidence that aligns with the H2 hypothesis of the present study, indicating that the level of board independence has a significant impact on the performance of Indian manufacturing enterprises. The findings of (Morri, 2013; Dani, 2018; and Kiptoo, 2021) provide more support to the argument that companies with a greater proportion of independent directors exhibit better results. Opposite to the findings of H2, but consistent with the findings of H3, Ghazali (2020) emphasized that board independence does not have a significant impact on company performance in Malaysia. This suggests that concerns regarding the effectiveness of board independence persist. The current study's findings provide additional validation due to the inconsistent outcomes shown in prior research regarding the influence of board independence on company performance.

Hypothesis H_4: *There is a significant impact of the board meetings on the Sri Lankan commercial banks' financial performance.*

The researcher applied both ROA and ROE metrics to evaluate the financial performance of publicly listed commercial banks in Sri Lanka. Based on the table below, both models indicate that the frequency of board meetings each year does not have a significant effect on the ROA and ROE. This is confirmed by the respective t-values of 0.50 and -0.16, which are both below 2, and the p-values of 0.631 and 0.876, which are both above 0.05. Thus, the researcher lacks sufficient information to reject the null hypothesis, which claims that board meetings have no significant effect on the financial performance of Sri Lankan commercial banks. To the opposite of this result, Ghazali (2020) emphasized the significant influence of the number of board meetings during the year has a substantial impact on the company's performance.

Hypothesis H_5: *There is a significant impact of the CEO duality on the Sri Lankan commercial banks' ROE.*

According to the table, model 2 suggests that CEO duality has an insignificant effect on the ROE because its t-value (0.39) is below 2 and its p-value (0.694) is over 0.05. Therefore, the researcher does not have sufficient evidence to reject the null hypothesis, which states that CEO duality does not have a substantial impact on the ROE of Sri Lankan commercial banks. Palaniappan (2017) and , Nguyen (2022) showed that CEO duality has a substantial impact on firm performance, which is contrary to the current study's findings. Additionally, they clarified that consolidating the roles of CEO and chairman into one individual will lead to improved performance for the organization.

Hypothesis H_6: *There is a significant impact of Gender diversity within the boards on the financial performance of Sri Lankan Commercial Banks.*

The researcher utilized both ROA and ROE metrics to assess the financial performance of publicly traded commercial banks in Sri Lanka. According to the table provided, both models suggest that the gender diversity of the board does not have a substantial impact on the ROA and ROE. These findings are supported by the respective t-values of 0.71 and 1.64, both of which are less than 2, as well as the p-values of 0.492 and 0.102, both of which are greater than 0.05. As a result, the researcher does not possess sufficient evidence to reject the null hypothesis, which posits that gender diversity does not have a significant influence on the financial performance of Sri Lankan commercial banks. In contrast to this result, Dani (2018) found that Gender diversity has a substantial effect on the firm performance in Brazilian companies.

Hypothesis H_7: *There is a significant impact of audit quality on the Sri Lankan commercial banks' return on equity.*

According to the table, model 2 suggests that Audit quality has an insignificant effect on the ROE because its t-value (0.11) is below 2 and its p-value (0.916) is over 0.05. Therefore, the researcher does not have sufficient evidence to reject the null hypothesis, which states that CEO duality does not have a substantial impact on the ROE of Sri Lankan commercial banks. Korent (2014) discovered that the quality of audits has a notable influence on the success of firms, indicating that companies audited by the four major audit firms exhibit better financial results.

Table 16- Summary of Regression Statistics

Variable	**Model 1 – ROA**		**Model 2 – ROE**		**Conclusion**
	t-values	*p-values*	t- values	p-values	
Ln_BS	2.40	0.037	-2.98	0.003	Do not reject the null hypothesis for both models
Ln_BI	-1.45	0.179	1.92	0.055	Reject the null hypothesis for model 1 Do not reject the null hypothesis for model 2
Ln_BM	0.50	0.631	-0.16	0.876	Do not reject null hypothesis for both models

CD	-	-	0.39	0.694	Do not reject the null hypothesis for model 1
GD	0.71	0.492	1.64	0.102	Do not reject null hypothesis for both models
AQ	-	-	0.11	0.916	Do not reject the null hypothesis for model 1

Source: Author Compiled

5. Conclusion

There is a higher grade of risk of the failure of various Sri Lankan banks even today due to their lack of CG mechanisms, according to the problem justification and the prior literature. Even if there is a robust regulatory framework in place, it is equally necessary to have a strong regulatory framework and a better governance structure. CG procedures are necessary to establishing and maintaining creditability in the banking system, and as a result, to guarantee the economy's and banking sector's smooth functioning. CG in the banking sector has drawn attention, nevertheless, especially in developing countries. This study identifies several aspects of Sri Lankan COBs' CG that are crucial, enabling the banks to develop strategies to improve CG. This boosts the bank's ability to compete in the financial sector and ensures its survival, particularly in this era of intense competition.

With the identification of practical and empirical significance, the significance of this study is spread to two directions. The empirical significance reveals by analyzing the CG effects determinants on the FP of Sri Lankan COBs, this study addresses the research gap in the literature. There is a lack of exploration in the local context, despite previous studies on CG and financial success. This report offers insightful information about the significance and role of CG in the industry of Sri Lanka's banking. When considering the practical significance of this study, reveals a significant correlation between factors of CG and a firm’s performance. This relationship varies depending on the country's nature, context, and culture. It helps regulatory parties like the SEC (Securities Exchange Commission), the Central Bank of Sri Lanka, and the CSE (CSE) identify proper governing mechanisms for financial institutions. Policymakers should prioritize internal CG aspects, and managers play a key operational role in selecting, implementing, and controlling CG practices. The design of the research project that will employ the quantitative method and the positivist paradigm based on secondary data is thoroughly detailed in the last section. The sample is drawn from listed COBs on the CSE. For the data analysis, SPSS 23 will be used to perform correlation analyses and regression analyses.

In conclusion, this study will analyze the effects of each board governance factor and audit quality on the performance of finance of Sri Lankan COBs, and it is expected to result in a satisfactory outcome at the implementation stage.

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