

# Influence of Corporate Governance on Financial Health of Nepalese Commercial Banks

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## Abstracts

*This study aims to measure the impact of corporate governance on financial health of commercial banks in Nepal. Return on assets, return on equity and earnings per share are the dependent variables used to measure financial health and corporate governance variables such as board size, audit committee size, audit committee meetings and board diligence are considered as independent variables. Primary and secondary data were collected through the administration of structured questionnaire and from the annual reports of commercial banks respectively. Convenience sampling was used to select the commercial banks located in Pokhara valley for collecting primary data. Simple random sampling was used to select 10 commercial banks (5 joint venture and 5 non joint venture banks) out of total population of 27 commercial banks for a time period of 2017/18 to 2019/20 for collecting secondary data. Multiple regression analysis and descriptive statistics were used in analyzing the data. Independent sample t-test was used to test the hypothesis in order to find out the relationship between corporate governance and financial performance.*

*The questionnaire survey reveals that board independence and audit committee independence are the most important variable for corporate governance. The primary data analysis concluded that small size board enhances the financial health. Transparency and disclosure is also an important feature of audit committee mechanisms. The analysis of secondary data reveals that audit committee meetings has a significant but inverse relationship with health of the commercial banks. The result indicates that priority should be given for quality of meetings but not the number of times such meetings are held due to the busyness of directors having better knowledge, expertise and their involvement in different sectors. The results support the idea that board busyness is useful factor for director quality. And busyness needs to be integrated with diligence to the extent that busy directors are diligent towards firms and they are able to exercise their expertise to positively influence firm performance. This study also helps the future researchers to conduct future research on impact of corporate governance on financial health to extend with new data and huge sample.*

**Keywords:** *corporate governance, financial health, board mechanisms, board diligence, audit committee mechanisms, return on assets, return on equity.*

## Introduction

The concept of corporate governance dates back to the 19th Century when state corporation laws enhanced the rights of corporate boards without unanimous consent of shareholders. Recently corporate governance becomes a hot topic among a wide spectrum

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of people, government, industry operations, directors, investors, shareholders, academics and international organizations to least but a few. Today's world has seen that organization transparency, financial disclosure, independency, board size, board composition, board committees, board diversity and among other is the cornerstone of good governance practices. These variables are in the main agenda of most meetings and conferences worldwide including the World Bank, International Monetary Fund (IMF) and The Organization for Economic Cooperation and Development (OECD) (Shungu et al., 2014).

Corporate governance indicates the policies and procedures applied by the firms to attain certain sets of objectives, corporate missions and visions with regard to stockholders, employees, customers, suppliers and different regulatory agencies and the community at large (Wise & Ali, 2009). Corporate governance is systematic and formalized manners of ensuring that top management represented by Board of directors do not make decision making powers occasioned by management and ownership separation to pursue personal interests at the expense of other stakeholders (Oghojafor et al., 2010).

The concept of corporate governance is popular with the emergence of agency problem when the ownership of companies is separated from the control thereof. Mahmood and Mahfuja (2007) state the need for corporate governance arises from the potential conflicts of interest among participants (stakeholders) in the corporate structure. These conflicts of interest often arise because different participants have different goals and preferences. Corporate governance (CG) was consequently introduced to ensure that the agents of the owners of companies in way that will serve the interests of the shareholders of the company (Gautam, 2017).

Financial health is also referred to the general measure of a firm's overall financial performance over a period of time and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation. Financial performance can be measured using proxies like profitability, return on equity, liquidity, solvency and sales growth and all these can be extracted from the financial statements. Information on financial performance is useful in predicting the capacity of the enterprise hence analyzing how well or poorly an enterprise is doing against its set objectives. Generally financial performance of business organizations can be measured using a combination of financial ratios analysis, benchmarking, measuring performance against budget or a mix of these methodologies (Opanga, 2013).

Good corporate governance practices can improve firms' stock in the long run and this can translate into a higher financial performance. Each element of the corporate governance statement e.g. board size, non-directorships, insider holding, board meeting frequency, number of resolutions passed in every meeting, presence of the chair in the meeting, rate of changing the CEO and composition of the board is assumed to increase the financial performance of a firm (Opanga, 2013).

Currently, the global organizations including Nepalese firms are being hurt by the inefficient and ineffective corporate governance resulting in huge collapse of business entities, banks and financial institutions and other related industry in the form of bankruptcy, liquidation, takeovers and other liquidity related issues. As the entire global economy is

dependent in manufacturing and service industry prudent corporate governance is inevitable for the well-being of global economy (Gautam, 2017).

The problem is that the banking industry is not free from corruption and unethical behavior. More or less some of the bank and financial institutions are still not fully responsible and accountable towards the organization itself and the board members are practicing wrong practices and non-transparency cases such as unfairness in employees' recruitment system, qualification relevance to board members, executive member meeting practice, preparation of financial statements, system of grievances handling. To bind above all factors in a system for running the banking industry in an efficient and effective manner, the study of corporate governance is indispensable (Gautam, 2017).

Corporate governance places a strong emphasis on the behavior of the corporation and how much the corporation discloses to the public. The banking industry will not operate efficiently and effectively until and unless the directors are honest, transparent and accountable towards the organization and the corporate governance is the only factor that will govern and regulate the organization and its stakeholders. It will clearly state the authority, responsibility and accountability of each of its stakeholders. For this purpose, this study also aims to examine those factors which have high influence to corporate governance (Klazema, 2014).

Though Nepal government and different regulator bodies are trying to comply with the corporate governance in its areas, there is some loop holes in the banks and financial institutions having some problems of the code of the conducts they really to follow and comply. Through the empirical studies, it is reviewed that board mechanisms and audit committee mechanisms were considered as important influencing variables of corporate governance on firm performance. Due to the emergence of issues or debates regarding board diligence and board busyness, this study needs to be empirically investigated in Nepalese banking context.

The study tends to find answer of these research questions.

- What is the current status of corporate governance in Nepalese commercial banks?
- Is there any relationship exists between CG variables and financial health indicators in commercial banks of Nepal?
- Is there any difference in the impacts of corporate governance on financial performance among joint venture and non-joint venture banks?

## **Objectives of the study**

The general objective of this study is to find out the relationship between corporate governance and financial performance in Nepalese banking system. The specific objectives of this study are as follows:

- To identify the current status of corporate governance practice in Nepalese commercial banks.

- To examine the relationship of corporate governance variables with financial health indicators in commercial banks of Nepal.
- To compare the impact of corporate governance on financial health among joint venture and non-joint venture banks.

## Hypotheses

- H<sub>1</sub>: There is significant relationship between board size and firm's financial health.
- H<sub>2</sub>: There is significant relationship between audit committee size and firm's financial health.
- H<sub>3</sub>: There is significant relationship between audit committee meetings and firm's financial health.
- H<sub>4</sub>: There is significant relationship between board diligence and firm's financial health.

## Theories of Corporate Governance

Agency Theory: The agency theory consists with the relationship between shareholders and managers as the classical principal-agent relationship, in which owners' employee managers to operate the firm in their best interest, while the managers are rewarded for their effort (Jensen & Meckling, 1976). The performance of the organization depends on the agents effort and the risk involved, but the agents' effort is not fully observable by the principal which causes asymmetry information. So that there seems difficulty to the principal to observe the efforts made by agent and compensate them for their efforts (Marashdeh, 2014).

Stakeholder Theory: The stakeholder theory presupposes the existence of number of groups within and outside organization with each having a stake and therefore they aspect accountability from organization (Lipunga, 2013). It explains desire for organizations to reflect social and environmental impact of the companies' activities specifically on employee related issues, community involvement, environmental concerns, other ethical issues (Branco & Rodrigues, 2006 as cited by Lipunga et al., 2013). Solomon (2007) has linked the stakeholder with the concept of CSR and emphasize that company should act in ethical manner.

Resource Dependency Theory: Resource dependency theory focus on high composition of number of executive directors in the board due to their access to the political and business contacts, wider knowledge and expertise and improved networking with external environment; thus improved access to resources which causes cheaper access to inputs and thus positively affects firm performance (Marashdeh, 2014). Additionally, directors may serve to link the external resources with the firm to overwhelm uncertainty (Hillman, Cannella Jr & Paetzols, 2000), because managing effectively with uncertainty is crucial for the existence of the company. According to the resource dependency rule, the directors bring resources such as information, skills, key constituents (suppliers, buyers, public policy decision makers, social

groups) and legitimacy that will reduce uncertainty (Gales & Kesner, 1994).

**Stewardship Theory:** Stewardship theory is an argument put forward in firm performance that satisfies the requirements of the interested parties resulting in dynamic performance equilibrium for balanced governance (Yusoff & Alhaji, 2012). Muth and Donaldson (1998) described stewardship theory as an alternative to agency theory which offers opposing predictions about the structuring of effective boards. While most of the governance theories are economic and finance in nature, the stewardship theory is sociological and psychological in nature. Stewardship theory argues that an insider-dominated board is more effective due to more comprehensive and deep knowledge of organizational daily operations, such as access to data and technical expertise (Muth & Donaldson, 1998).

**Legitimacy Theory :** The legitimacy theory is based on the notion of a 'social contract', which limits the activities of an organization within the boundaries set by the society (Khan et al., 2012). Through review of various literatures, Khan et al. (2012) pointed out that if there are differences between the organizational actions and boundaries set by the society then a legitimacy gap is formed. Legitimacy theory therefore implies that it is the top management of an organization which is responsible to recognize legitimacy gap and carry out necessary social practices and disclosure that accordingly to stakeholders to ensure accountability. Thus, corporate governance in particular, the internal governance structure (such as ownership and board composition) is likely to play a vital role in reducing legitimacy gap through extended corporate social responsibility (CSR) disclosures (Khan et al., 2012).

## **Methodology**

Both descriptive and correlational research design have been used in the study. The research was descriptive in nature as it would describe data and characteristics related to the corporate governance in detail. The research was also correlational since this study showed the relationship among dependent and independent variables i.e. financial health and corporate governance. The populations of the study were the number of commercial banks in Nepalese banking industry. Convenience sampling was used to select the commercial banks located in Pokhara valley for collecting primary data. Simple random sampling is used for selecting 10 sample banks (5 joint venture and 5 non joint venture banks) for secondary data. For selecting the sample from banks, the total commercial banks were divided into two groups namely non-joint venture banks and joint venture banks. Quantitative nature of data were used in this study. Similarly, primary and secondary sources of data were used in this study. Primary data were collected through questionnaire. The questionnaire survey has been conducted to record the perceptions and opinions of 95 respondents including bank managers and staffs of commercial banks located in Pokhara valley regarding the corporate governance practices. Secondary data were from annual reports of selected banks in order to analyze the financial performance of the respective banks. This study has covered 3 years specific data for the period of 2017/18 to 2019/20. The key instrument used in the study is the structured questionnaire which was designed to meet the stated objectives of the research. For primary data collection, a set of questionnaire is utilized as instrument consisting of multiple choice questions, yes/no questions, ranking questions and open-ended questions and distributed to

the respondents of commercial banks of Pokhara valley. For secondary data collection, annual reports were downloaded from respective banks websites. Data on independent variables and dependent variables board size, audit committee size, audit committee meetings, board diligence and ROA, ROE, EPS were obtained from the annual reports. The data collected from the annual reports were entered in SPSS and MS-Excel. Descriptive analysis and inferential analysis were carried out. Under descriptive statistic; mean, standard deviation, maximum and minimum values of the variables under study were calculated. Correlation analysis and multiple regression analysis were performed. Tables were constructed where appropriate. Under inferential analysis, hypotheses were tested using independent sample t-test.

### Multiple Regression Model

The study has specified several regression models to analyze the relationship between the mechanism of corporate governance and bank performance. The dependent variables are ROE, ROA and EPS which are the proxy for performance of the banks. The following regression models have been tested.

Multiple regression equation is given by:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + e$$

#### Model 1:

$$ROE = \beta_0 + \beta_1 BSize + \beta_2 AudComSize + \beta_3 AudComMe + \beta_4 BD + e$$

#### Model 2:

$$ROA = \beta_0 + \beta_1 BSize + \beta_2 AudComSize + \beta_3 AudComMe + \beta_4 BD + e$$

#### Model 3:

$$EPS = \beta_0 + \beta_1 BSize + \beta_2 AudComSize + \beta_3 AudComMe + \beta_4 BD + e$$

Where, Y = Dependent Variable

$X_1, X_2, X_3$  and  $X_4$  are independent variables

$\beta_0$  = intercept

$\beta_1$  = coefficient of board size

$\beta_2$  = coefficient of audit committee size

$\beta_3$  = coefficient of audit committee meeting

$\beta_4$  = coefficient of board diligence

BSize = board size

AudComSize = audit committee size

AudComMe = audit committee meeting

BD = board diligence

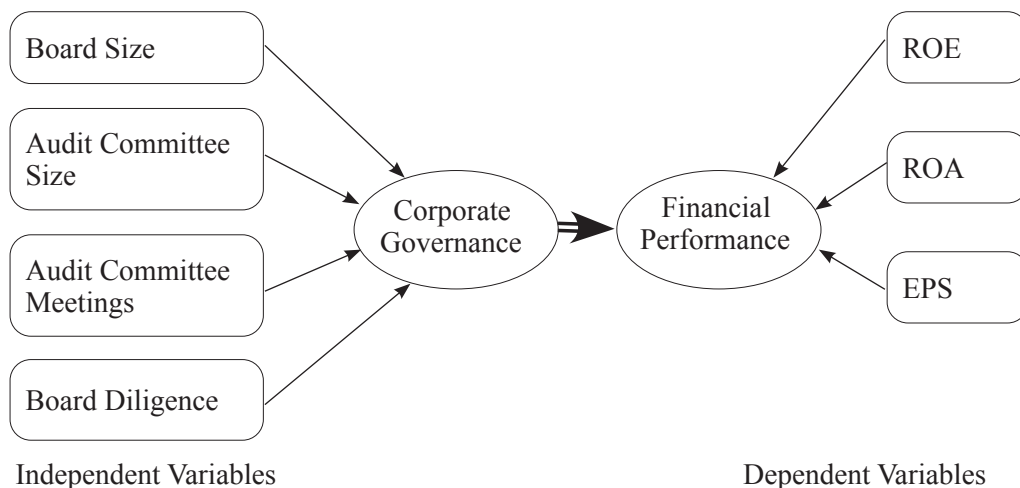
e = error items



Firms' financial performance is the dependent variable and the corporate governance characteristics like board size, number of audit committee, audit committee meetings and board of directors (BOD) meetings are the major independent variables under study.

**Figure 1**

Conceptual Framework



**Board Size:** It refers to the total number of directors on the board of the bank. The optimum size of the board depends upon the circumstances of the company, the qualities of the directors and how the business of the board is conducted.

**Audit Committee Size :** Effective audit committee ensures the fair view of financial reporting. Audit committee plays a vital role to influence the firm performance through its monitoring role. Audit committee size is one of the independent variable of the study.

**Audit Committee Meetings :** Audit committee is the operating committee chaired by one of the board members of the bank that is responsible to oversee financial reporting and disclosure. Frequency of audit committee meetings have positive, negative and non-monitoring role on firm performance.

**Board Diligence :** Board diligence is measured by frequency of board meetings. Board meeting is a meeting of a company's board of directors, held usually at certain times of the year to discuss company-wide policies or issues. The frequency of board meeting is considered as an indicator to judge the efficiency of board.

**Return on Equity (ROE):** The ROE shows the extent to which a bank is successful to mobilize its equity. It is measuring rod of the profitability. A high ratio indicates the success of bank in mobilizing its equity capital and vice-versa.

**Return on Assets (ROA):** Return on assets is an indicator of how profitable a company is before leverage, and is compared with companies in the same industry.

Earnings per Share (EPS): Earnings per share are the portion of a company's profit allocated to each outstanding share of common stock.

## **Findings**

This study has tried to identify impact corporate governance on financial health of Nepalese commercial banks. Board size, audit committee size, audit committee meetings and board diligence are the most important corporate governance structure and mechanism that is expected to influence the performance of the banks.

The major findings of this study are the average ROA of all sample banks is 1.6367 percent while mean ROE is 13.1807 percent. The mean EPS is 24.7940 per share. The board size ranged between 5 to 8 averaging 6.7667 members. The average audit committee size is 3.1667 members ranging from minimum 3 to maximum 5 members. On average, about 13.1 audit committee meetings were held and 25.4 board of directors meetings were held. The average ROA, average board size and average audit committee size were almost similar for NJV and JV banks. The average ROE and average EPS of JV banks is higher than that of NJV banks reflecting that JV banks have more profitability than that of NJV banks. On average, the frequency of audit committee meetings and board diligence of NJV banks are higher than that of JV banks indicating that NJV banks conduct more meetings of both types than JV banks. The differences between mean and S.D of ROA, ROE and EPS of JV banks are higher than that of NJV banks which indicates that JV banks have greater variations in bank performance indicators. Likewise, the variation between the mean and S.D of audit committee size, frequency of audit committee meetings and board diligence of JV banks are higher than that of NJV banks. This result shows that NJV banks have greater variability in corporate governance mechanisms except of board size.

As shown by correlation analysis, for joint venture banks and non joint venture banks, ROA, ROE and EPS are insignificantly correlated with Board Size, Audit Committee Size, Audit Committee Meeting and Board Diligence. Board Size and Board Diligence are negatively and insignificantly correlated with ROA when all sample banks are taken into account. ROA is negatively but significantly correlated with AudComMe at 5% level of significance. AudComSize is positively but insignificantly correlated with ROA. Similarly, ROE and EPS are negatively and insignificantly correlated with BSize, AudComSize, AudComMe and BD.

The results of multiple regression analysis reveals that ROA, ROE and EPS have no significant relationship with board size, audit committee size, audit committee meetings and board diligence for NJV banks. For JV banks, ROA, ROE and EPS have no significant relationship with four explanatory variables of the study. For all bank type, there is significant but negative association of ROA, ROE and EPS with audit committee meetings at 5% significance level. However, ROA, ROE and EPS have no significant relationship with other three explanatory variables.

As indicated by  $R^2$ , about 3.2%, 20.5% and 19.2% variations in ROA is explained by the variables of the study: board size, audit committee size, frequency of audit committee



meetings and board diligence for NJV, JV and all bank type respectively. The remaining variations for each bank type are due to other unknown variables.  $R^2$  of 12.8%, 31% and 19.3% indicate that the variations in ROE which is explained by the variables: board size, audit committee size, frequency of audit committee meetings and board diligence for NJV, JV and all bank type respectively. The remaining variations for each bank type are due to other explanatory variables. 7%, 34.7% and 18.6% variations in EPS as indicated by  $R^2$  is explained by the explanatory variables: board size, audit committee size, frequency of audit committee meetings and board diligence for NJV, JV and all bank type respectively. The remaining variations for each bank type are due to other unknown variables. Independent sample t-test provides sufficient evidence that there is significant difference in mean score of audit committee meetings, ROA, ROE and EPS by bank type (joint venture and non joint venture) at 5% level of significance. However, there is no significant difference in mean score of board size, audit committee size and board diligence by bank type.

From the analysis of primary data, it is observed that 70.5% of respondents are satisfied with the effective corporate governance mechanism which is linked towards the better performance of banks in Nepal. 7.4% and 22.1% respondents are not satisfied and have no idea about that respectively. 68.4% of respondents present that the banks have well written corporate governance policies. Likewise, 66.3% of the respondents indicate that banks are more prone to risk of failures due to bad corporate governance practices. It is revealed that 34.7% of banks often reviews and make corrections of corporate governance practices and 44.2% of banks make sometime review and corrections. Similarly, 11.6% rarely makes review and corrections and 2.1% never review and make corrections of corporate governance practices. Only 12.6% of the respondents prefer ensuring the effectiveness of various governance practices should be the prime focus of the board of directors. Likewise, 80% of the respondents believe that board independence is the most influencing variable for corporate governance. 53.7% believe that board size as the second important factor of corporate governance. 68.4% of respondents rank first for the audit independence and 45.3% rank second for the transparency and disclosure as the important feature of audit committee mechanisms. 33.7% rank audit activity or meetings as third and 16.8% of respondents rank audit committee size as fourth feature. 60% of respondents viewed that board size affects the firm performance and 31.6% disagreed with the statement. Similarly, 51.6% of respondents agreed that the smaller the board size better are the performance where 31.6% disagreed and 16.8% had no idea about that. Likewise, 33.7% of respondents agreed current practices of CG are enough for reducing expropriation or misallocation of funds. 77.9% of respondents agreed that the BOD should be composed of more independent directors and 54.7% agreed that the audit committee is genuinely independent in banks. 66.3% of the respondents disagreed that the audit committee meets and reports regularly to the BOD and 53.7% of respondents agreed that there should be transparency and openness for good corporate governance.

## **Discussion**

The analysis of the primary and the secondary data shows the findings with regard to the effect of corporate governance structure on performance of banks.

The analysis of primary data showed that most of the banks have effective corporate governance mechanism which is linked toward the better performance of banks. Most of the banks also have well written corporate governance policies and banks are more prone to risk of failures due to bad corporate governance practices. The study also revealed that most of the banks make often reviews and corrections of corporate governance practices. The analysis also reveals board mechanisms, audit committee mechanisms as the corporate governance variables that influence the performance of the banks in order of their importance. The study also reveals that the most important factor that mostly influences the corporate governance variable in Nepalese commercial bank is board independence. Board size is the second influencing factor of corporate governance variables and the least factor is board tenure. Similarly the most influencing feature for audit committee mechanisms in Nepalese commercial bank is audit independence and the second influencing feature is transparency and disclosure which is supported by Adhikari (2014). Therefore, the bank must disclose all the require information so that right information could be use on the right time for the better performance of the banks. The least influencing feature for audit committee mechanism is audit size. The results are supported by Krishnan (2012) and Pandey (2014) who investigated that board independence and audit committee independence are the most influencing variables of corporate governance that affects the performance of the firms.

In the analysis of JV and NJV banks, JV banks have better mean ROA, ROE and EPS that of NJV banks which indicates better financial performance of JV banks. The results are contradicted with Jha & Hui (2012) who found out public banks were less efficient and both JV and NJV banks were equally efficient while comparing their performance. And similarly, the findings of this study are also contradicted with Chandulal (2016) who presented that public banks have high ROE so that public banks have better performance than JV and NJV banks.

When viewed in total sample of the study including joint venture and non-joint venture banks the corporate governance mechanisms like board size, audit committee size and board diligence do not influence the ROE, ROA and EPS. Further, the objective is to compare the impact of corporate governance on financial performance among joint venture and non joint venture banks. If the joint venture and non-joint venture banks are compared separately then, the corporate governance mechanisms like board size, audit committee size and board diligence are observed to have insignificant impacts on ROE, ROA and EPS.

The study revealed significant negative association of audit committee meetings which depicts that larger number of audit committee meetings tends to affect the performance of the banks. The significant finding of this study is the negative role of audit committee meetings on firm performance and the finding is in agreement with Robeiz and Salameh (2006). The results that smaller number of audit committee meetings ensures the higher performance of the banks contradict with Pandey (2014), Aanu et al. (2014) and Alquatamin (2018). Similarly, the insignificant relationship of board size, audit committee size and board diligence with the performance of the banks is challenged by Ghimire (2017), Hong Vn and Nguyen (2017) and

Kwame (2017) and supported by Pandey (2014) and Alagathurai and Nimalathashan (2013).

## **Conclusion**

The study considered four corporate governance attributes: board size, audit committee size, audit committee meetings and board diligence to examine their association with the performance of the banks.

The statistical results revealed that there is no significant relationship of corporate governance variables except audit committee meetings with the performance of the banks. The study concluded that significant but inverse association of audit committee meetings with the financial performance for all bank type. The negative effect of frequency of audit meetings on profitability indicates that quality of meetings should be given priority but not the number of times such meetings are held due to the busyness of expert directors and their involvement in different sectors. However, the study found that board size, audit committee size, audit committee meetings and board diligence have no significant relationship with the financial performance for joint and non joint venture banks.

The primary data analysis concluded that small size board enhances the financial performance. Most of the banks have well written corporate governance practices and they are often reviewing and making corrections of corporate governance practices. Transparency and disclosure is also an important feature of audit committee mechanisms that's why banks should focus on transparency and proper disclosure of all activities and information. The questionnaire survey among bank employees indicates the board independence and audit committee independence of banks bounds the management to adopt fair corporate governance practices thereby enhancing the performance.

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