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# CORPORATE GOVERNANCE AND ITS IMPACT ON FINANCIAL PERFORMANCE OF NEPALESE COMMERCIAL BANKS

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## ABSTRACT

*This study aims to analyze the relationship of corporate governance structure with performance of banks. Based on the reviews of studies this study has conceptual model for the study that essentially emphasize on the role of board structure and mechanism and audit committee mechanism in shaping the performance of the banks. Primary data has been collected through questionnaire survey among employees and responses, percentages has been used to analyze the primary data while descriptive Statistics, correlation analysis, regression have been carried out to examine the mean and standard deviation. The performance measures like Return on Equity (ROE), Return on Assets (ROA) of the banks have been used as the dependent variable while corporate governance variables like board size, board independence, audit independence and audit activity, CEO duality and have been considered as independent variables.*

*Based on the results of primary data, board size, CEO duality and corporate governance needs are important corporate governance mechanism in order of their relative importance that enhances the performance of the banks. To be more specific, board independence, CEO duality and audit committee independence are the corporate governance mechanisms that tend to influence the performance in positive manner. It implies that increase in any of these variables is likely to increase the performance of the banks. The study recommends the banks to improve the level of corporate governance that not only improve the performance of an individual bank but also ensures the stability of banking system. Moreover, banks are suggested to adopt faire corporate governance practices to promote market confidence, attract additional capital through good disclosure and transparency.*

**KEYWORDS**: *Corporate Governance, Return on Assets, Return on Equity, Commercial Banks, Nepal.*

## INTRODUCTION

Governance simply refers to the process or act of governing .When it comes to the organized sector .corporate sector, it is the way by which organization is organized. Corporate governance refers to the ways a corporation is governed. It is the technique by which companies are directed and managed. It identifies who has power and accountability and who makes decision. It guarantees that an enterprise is directed and controlled in a responsible and transparent manner with the purpose of safeguarding its long term success. It is intended to increase the confidence of stakeholders (CFI 2021).

Corporate governance is not merely the governing of certain form of organization. The concept has been used by different people differently and still there is no inversely accepted definition of corporate government. (Rezaee, 2009). In an ideal world, managers would invest all of their abilities of skills to generate best possible return for investors. In the real world, things are slightly different. A series of unexpected corporate failure in 1990's brought to the attention of importance of corporate governance system. (Deacons and o'sulivan). "Corporate governance deals with the way suppliers of finance to corporations assure themselves of getting return on their investment." (Shleifer and Vishny 1997 P.737). "Corporate government refers to the design of institution that induce or force the management to internalize the welfare of stakeholders." (Tirole 2001, P.4) "The term corporate governance essentially refers to relationship among management, Board of director, shareholders and other stakeholder in a company."

Corporate governance refers to the private and public institutions, including laws, regulations and accepted business practices, which together govern the relationship, in and market economy, between corporate managers and entrepreneurs (corporate insiders) in one hand, and those who invest resources in corporations on other (Oman 2011). The relationship between CG and firm's performance has been widely debated and well-researched topic in developed countries content. However, in the past few years, this issue has also been discussed in developing and underdeveloped countries too because of recent corporate collapses and scams. The firms with weaker governance structure have to face more agency problem and managers of such firms gain more private benefits. Firm's governance plays a very important role in probability of Accounting frauds and firms which have weak governance structure being more prone to accounting frauds (Core et al. 1999). CG has been an important research area which deals with the various governance arrangements used to control the corporation within the objective of maximizing shareholder's wealth (Berklman, Dimitrob, Jain, Koch, & Tice, 2009). Tsamenyi et al, (2007) have argued that there is multitude of problems faced by developing economies, including the risk and uncertainty, political instability weak legislation, high level of government intervention and low level of protection for investors. As such, there is necessity for effective structure of CG to be adopted.

In order to achieve good corporate governance, it is important for company to adopt clear standards and full disclosure ( (Rajagopalan & Zhang, 2008). Implementing CG principles will lead to a better avoidance of pervasive corruption cases and nepotism and helps to attract more local and foreign investment (Rajagopalan and Zhang, 2008). Thus, creating a better environment would offer more employment opportunities and improve standard of living as a whole. Sound corporate performance is believed to be essential for maintaining investors' confidence and good performance to solve problems of corporate miscount and behave. In the modern globalize age, corporate governance and financial performance has become more challenging and burning issues all over the developed and developing countries.

Effective corporate governance emphasizes the objectives to align the corporate goal with goal of its stakeholders, to strengthen corporate functioning and discouraging management, to achieve the corporate goals by making investment in profitable investment outlets and to specify the responsibility of board of directors and managers in order to ensure good corporate performance.

In developing countries like Nepal, a good governance of banks is crucial for the survival of its economy. In Nepal, liquidation of several institution like: Nepal Development Bank, Gorkha Development Bank, Shreeram Sugar Mills, Bansbari leather and shoes, etc. and poor performance of various public enterprises focuses for consideration about issues of CG and financial performance.

Corporate governance can have positive effect on business growth by making it easier for corporation to raise necessary capital to acquire new territory or develop a new product. Good corporate governance ensures that organization is managed in full manner that fits the best interest of all. In last decade, corporate governance has gained immense and serious attention because of high profile scams and criminal activity by officers in power. Corporate governance has a broad scope. It includes both social and institutional aspect. It is all about balancing individual, societal and economic goals. It is actually conducted by board of directors and concerned committee for company stakeholder's benefit. It is important for Nepalese commercial bank to improve the level of corporate governance that not only improve the performance of individual but also ensures the stability of banking system.

Banks uses the term "corporate governance" refers to governance of structure of organization and operational practices of its leadership and management. Banks are suggested to adopt fair corporate governance practices to promote market confidence and attract additional capital through good disclosure and transparency. The need for corporate governance needs to be realized. Large number of Nepalese corporation used several illegal tactics with view to keep away competitors, illegally holding money abroad and indulging in bribery and corruption. Corporate governance failures are another important aspect which needs to be essentially considered. It does not happen overnight.

Significant transformation of the banking industry in Nepal is clearly evident from the changes that have occurred in financial market, institutions, products and services. While open door policy has opened up new opportunities for banks to boost revenues, it has entailed greater competition and consequently greater risk.

Company Act (2006), BAFIA Act and unified directives of NRB are acts and regulations which provide necessary guidelines to maintain corporate governance in bank and financial intuition. Nepal Government and central bank are working to develop transparent, competitive and strong financial sector. Corporate governance has been a fundamental subject of concern in emerging economics.

In light of these facts associated with corporate governance, it is necessary to examine how far banks in Nepal have been adopting the sound corporate governance practices and how far the corporate governance serve as leading indicator of better performance.

### 1.1 Statement of Problem

Corporate governance has always been subject of controversy; no matter whatever is nature or structure of organization as corporate governance is about maintaining business ethics, norms and values. Some organizations find it really hard and challenges due to lack of managerial expertise and knowledge. Becht et al, (2002) agree that the corporate governance arises whenever an outside investor wishes to exercise control differently from the manager in charge the firm. Effective corporate governance should fundamentally guarantee shareholders value by ensuring the appropriate use of firm's resources, enabling access to capital and improving investors' confidence (Denish and Mc Connell, 2003)

The area of corporate governance has acquired heightened attention in last decades because of various notable corporate scandals like: Enron, WorldCom, sat yam etc. which involves unethical business practices. Unless a corporation embraces and demonstrates ethical conduct, it will not be able to success. The fate of every entity is eventually determined by its governance. Through an organization may succeed in short span of time with inadequate focus on corporate governance, but in the long run, it can never succeed. Thus, considering the global example of outcome of poor corporate governance and contemporary Nepalese market, the need of strict focus on corporate governance is indispensable. Governance mechanisms are the tools that principals and agents used to monitor and control agents (Pallathitta, 2005). These mechanisms are therefore utilized to ensure that agents act in a manner that is in best interest of their principal. Among other, board structure and audit committee mechanism are of growing importance.

The board of directors is known as one of the most essential tools to resolve corporate governance problem. Since, it is an organ primarily used by other stakeholders, to monitor management. (Jensen, 1993). Large board size should be preferred to small size because of possibility of specialization for more effective monitoring and advising functions (Klein, 2002). In addition, the idea of value additive of gender diversity in the board has received argument-ed interest. Female directors are considered to be hard working and have better communication ability, which contributes to improved problem solving and decision making ability.

The extent to which board structure and audit committee mechanism are functioning well in Nepal is still clearly unknown. Pradhan and Adhikari (2009) looked at corporate governance and financial performance and found the significant rule of ownership structure and audit committee mechanism on firm performance. Sapkota (2008) focused on corporate governance of financial institution in Nepal. Moreover, positive relationship of board size and audit committee size wealth efficiency of banks in Nepal was documented by Poudel and Hovey (2012).Despite of some studies, the relation of corporate governance variables with bank performance in Nepalese banking sector is not yet known completely.

Although there are several directives and regulations to strengthening the situation of corporate governance by Nepal Rastra Bank, there is a gap of policy and implementation of policy in Nepalese banking industry that can be observed by the default of bank and financial institutions in Nepal. The real estate crisis of Nepal in the period from 2007 to 2009 further highlighted the importance of corporate governance in Nepalese banking industry. Therefore, the corporate governance of bank is more importance than other industries (Adnan et al., 2011).

The study is initiated to conduct following research problems:

1. Is there any relationship between board size and bank performance?
2. What is the relationship between the firm performance and corporate governance variables such as CEO duality?

3. Does the major proportion of independent directors in board enhance corporate governance of bank?
4. Does ineffective corporate governance practices hampers financial performance of banks?

**1.2 Objective of the study**

Various studies have showed that good corporate governance practices have led to significant increase in economic value added to firm, higher productivity and lower risk of financial failures. For developing countries like Nepal, improving corporate governance can serve number of policy objectives. The basic objective of this study is to examine the relationship between corporate governance and bank performance in Nepal.

However, the specific objectives of this study are:

1. To analyze the relationship of board size with bank performance.

2. To assess the relationship between firm performance and corporate governance variables such as CEO duality.

3. To examine the impact of board interdependence on banks performance.

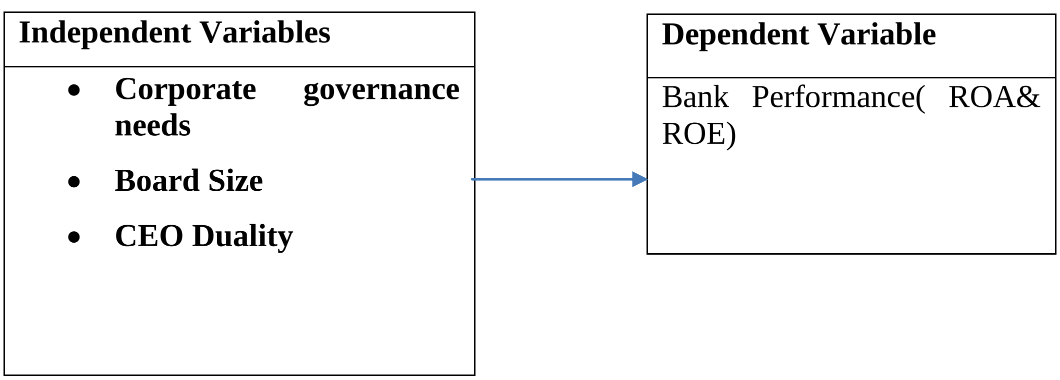
4. To analyze ineffective corporate governance practices whether harms performance of bank or not.

**1.3 Research framework and Definition of Variables**

Even though, the elements and structure vary from country to country and one industry to another, the most crucial element of CG in context of banking industry can be shown through following conceptual framework:

**Figure 1**

**Research Framework**




Governance simply refers to the process or act of governing. When it comes to the organized corporate sector, it is the way by which organization is organized. Corporate governance refers to the ways a corporation is governed. It is the technique by which companies are directed and managed. It identifies who has power and accountability and who makes decision. It guarantees that an enterprise is directed and controlled in a responsible and transparent manner with the purpose of safeguarding its long-term success. It is intended to increase the confidence of stakeholders.

On the contrary, commercial bank refers to financial institution which accepts deposits, makes business loans and offers related services. They are authorized by law to receive money from business and individuals and lend money to them. In context of Nepal the example can be Nepal Bank limited, first commercial bank of Nepal.

Corporate governance can have positive effect on business growth by making it easier for corporation to raise necessary capital to acquire new territory or develop a new product. Good corporate governance ensures that organization is managed in full manner that fits the best interest of all. In last decade, corporate governance has gained immense and serious attention because of high profile scams and criminal activity by officers in power. Corporate governance has a broad scope. It includes both social and institutional aspect. It is all about balancing individual, societal and economic goals. It is actually conducted by board of directors and concerned committee for company stakeholder's benefit. It is important for Nepalese commercial bank to improve the level of corporate governance that not only improve the performance of individual but also ensures the stability of banking system.

The banks uses the term "corporate governance" refers to governance of structure of organization and operational practices of its leadership and management. Banks are suggested to adopt fair corporate governance practices to promote market confidence and attract additional capital through good disclosure and transparency. The need for corporate governance needs to be realized. Large number of Nepalese corporation used several illegal tactics with view to keep away competitors, illegally holding money abroad and indulging in bribery and corruption. Corporate governance failures are another important aspect which needs to be essentially considered. It does not happen overnight.

Corporate governance system aims at promoting healthy market practice and reducing financial difficulties arising due to agency problem. Corporate governance has been a fundamental subject of concern in emerging economies as well. In light of these facts associated with corporate governance, it is necessary to examine how far banks have been adopting sound corporate governance practices and how far corporate governance serves as leading indicator of better performance.

To be more specific, the result of these multivariate analyses showed that the size of audit committee and expertise of its member have a positive and significant impact on financial performance measured by ROE and audit committee independence have significant positive impact on ROA. In addition, it was observed that the existence of at least one member of audit committee with professional accounting or experience in account or finance can improve financial performance of companies in Tunisia.

The study revealed that a negative significant relationship between percentage of independent directors in audit committee and bank performance in terms of both ROA and ROE. The results determined that other dimension of CG. (Board interdependence, board committee existence, remuneration) don't have statistically significant relationship with bank group profitability. (Romano et al, 2012)

## 2. METHODOLOGY

This research aims at identifying the effects of corporate governance on the financial performance of commercial banks in Nepal, so descriptive as well as casual comparative research designs have been chosen for the study. Since the findings of the study were measured, calculated, and evaluated through numbers and perceptions of employees of commercial banks, this research follows the quantitative as well as qualitative study method. The data collected through this study were quantifiable and thus provided empirical answers to the research questions.In this research, the populations were the employees of commercial banks in Nepal. There were 27 commercial banks in Nepal during the end of fiscal year, 2020. The data was collected through primary sampling were the researcher had provided questionnaire to specific population to collect the data for analysis. From a total sample size of 500 respondents of all commercial banks, 450 were surveyed due to no response shown by the 50 of the respondents. They were surveyed to analyze employees' perception towards the financial performance in Nepalese commercial banks. Convenient judgmental sampling was used. For analyzing data, software such as SPSS, MS Excel and Google Form were used. After explaining the demographic profiles of respondents, various descriptive as well as inferential statistical measurements such as percentage of frequency table, mean, standard deviation, correlation table and regression model were used to establish a relationship between the independent and dependent variables.

## 3. RESULTS AND DISCUSSION

3.1 Descriptive Statistics

The table shows the descriptive statistics of Corporate Governance Needs, Board Size and CEO duality and financial performance of all 27 commercial banks of 450 observations. Descriptive statistics includes mean and standard deviation.

**TABLE: 1 MEAN AND STANDARD DEVIATION OF DEPENDENT AND INDEPENDENT VARIABLES**

| variables | Mean | Std. Deviation |
|---|---|---|
| Corporate Governance Needs | 3.6341 | 0.90124 |
| Board Size | 3.6314 | 0.96667 |
| CEO Duality | 3.3171 | 0.76666 |
| Financial Performance | 3.6649 | 0.92973 |

**Source:** Field survey report, 2022

Table 1 depicts the mixed performance regarding the performance of banks. The mean is essentially a model of data set that produces the lowest amount of error from all other values in the data set. The above descriptive analysis shows that mean of corporate governance need is 3.63 whereas mean of board size is 3.631. Again mean of CEO duality is 3.317 whereas mean of financial performance is 3.664.

Standard deviation tells us on an average how far each score simply lies from mean. High stand deviation means that value are generally far from mean , while low standard deviation indicates that the values are clustered close to mean. If the standard deviation is low, then it is considered to be more reliable and if the standard deviation is greater, then it is considered be less reliable. The above table represents that the standard deviation with respect to corporate governance variables being less than 1 i.e. higher being 0.96667 and the lower being 0.76666 which indicates the sets of data are more reliable. According to Cohen (2003) for the normal distribution of data standard deviation must have range of 0 to 1. As it is evident that the standard deviation of 3 variable falls within the range, the data may be consider normally distributed.

### 3.2 Inferential Statistics

Inferential statistics are concerned with making inferences based on relations found in the sample, to relations in the population. Inferential statistics help us decide, whether the differences between groups that we see in our data are strong enough to provide support for our hypothesis that group differences exist in general, in the entire population.

3.2.1 Coefficients of Correlation

Correlation Analysis is statistical method that is used to discover if there is a relationship between two variables/datasets, and how strong that relationship may be. Any score from +0.5 to +1 indicates a very strong positive correlation, which means that they both increase at the same time. Any score from -0.5 to -1 indicate a strong negative correlation, which means that as one variable increases, the other decreases proportionally. Very simply, a score of 0 indicates that there is no correlation, or relationship, between the two variables. The larger the sample size, the more accurate the result. No matter which formula is used, this fact will stand true for all. The more data there is in putted into the formula, the more accurate the end result will.

**TABLE: 2 CORRELATION COEFFICIENTS OF DIFFERENT VARIABLES**

**Correlations**

| | | CG | BS | CD | FP |
|---|---|---|---|---|---|
| CG | Pearson Correlation | 1 | .923$^{**}$ | .809$^{**}$ | . .908$^{**}$ |
| | Sig. (2-tailed) | | .000 | .000 | .000 |
| | N | | 440 | 440 | 440 |
| BS | Pearson Correlation | | 1 | .801$^{**}$ | .920$^{**}$ |
| | Sig. (2-tailed) | | | .000 | .000 |
| | N | | | 440 | 440 |
| CD | Pearson Correlation | | | 1 | .803$^{**}$ |
| | Sig. (2-tailed) | | | | .000 |
| | N | | | | 440 |
| FP | Pearson Correlation | | | | 1 |
| | Sig. (2-tailed) | | | | |
| | N | | | | |

The correlation table above clearly advocates that there is very strong positive correlation between corporate governance needs and financial performance, as the value of r= (0.908). It simply signifies that with the increment in one variable, the other variable also increases.

Moving up to next corporate governance variable i.e. Board size, there is again positive correlations between board size and financial performance of the bank. It simply signifies that with the increment in board size, the financial performance increases as well as the value of r being .0920. Also, there exist positive correlation between CEO duality and financial performance as the value of r= 0.803 which falls in between o.5 to 1. It advocated that the variable CEO duality is directly with the financial performance of the bank.

The p value is recorded to be 0.000 that is highly significant, so that it can be said that within the given sample there is positive relationship between financial performance and corporate governance needs, training program and employee motivation. Further, it can be interpreted that increase in one variable result in increase in another one also. Result concluded hypothesis 1, 2 and 3 is accepted at 0.01 level of significance

On the whole, the conclusion comes up to an understanding that there exist positive correlation between corporate governance variables and financial performance of the bank, as the increase in one variable leads to increment in another variable and decrease in one variable leads to the decrease in the same.

### 3.2.2 Regression Analysis:

Multiple regression analysis could be described as a statistical technique which is used to analyze the relationship between a single dependent (criterion) variable and several independent (predictor) variables. The objective of multiple regression analysis is to predict the changes in the dependent variable in response to changes in the independent variables. It can be interpreted as how good a predictor your multiple regressionsare likely to be. Also, a multiple determination can be interpreted as the percentage of variation in the dependent variables that can be explained by the regression equation. Regression analysis was computed to test three hypotheses-hypothesis 1: positive relationship between financial performance and corporate governance needs, hypothesis 2: positive relationship between financial performance and board size and hypothesis 3: positive relationship between financial performance and CEO duality.

The regression table provides the result of constant, coefficient of determination, t-value. Coefficient is the slope of regression line and it explains that 1 unit change in independent variable will bring how much change in dependent variable. The coefficient of determination ($R^2$) explains how much variation in the dependent variable is explained by the independent variable.

**TABLE: 3 REGRESSION RESULTS OF BANK'S FINANCIAL PERFORMANCE AS DEPENDENT VARIABLE AND CORPORATE GOVERNANCE AS INDEPENDENT VARIABLES**

| Model | Unstandardized Coefficients | | Standardized Coefficients | T | Sig. | 95.0% Confidence interval for B | |
|---|---|---|---|---|---|---|---|
| | B | Std. Error | Beta | | | Lower Bound | Upper Bound |
| 1 | .127 | .072 | | 1.776 | .077 | -0.014 | .26 8 |
| (Constant) | .353 | .048 | 0.342 | 7.407 | .000 | .259 | .446 |
| CG | .491 | .044 | 0.510 | 11.248 | .000 | .405 | .577 |
| BS | .142 | .036 | 0.117 | 3.955 | .000 | .072 | .213 |
| CD | | | | | | | |
| $R^2$=0.875 | F=1015 | | d.f.=3,436 | | | | |

Regression coefficient results in the table depict that independent variables (corporate governance Needs, board size and CEO duality) contribute significantly (p=<0.05 and = 0.05) to the financial performance.

The result of regression interprets the coefficient value 0.342 which shows that one percent change in corporate governance needs (independent variable) can result in 34.2% change in financial performance (dependent variable). Therefore if independent variable (corporate governance needs) is increased by 1%, this will result in 34.20% increase in dependent variable (financial performance). The t value of the hypothesis is 7.407 that corporate government need is a major predictor of financial performance.

The results of regression interprets the coefficient value 0.510 which shows that 1% change in board size (independent variable) can result in 51% change in financial performance (dependent variable) therefore if the independent variable increased by 1% this will result in 51% increase in dependent variable. The t value for the hypothesis is 11.248 that board size is the major predictor of financial performance

The result of regression interprets the coefficient value 0.117 which shows 1%change in CEO duality (independent variable) can result in 11.7% change in financial performance (dependent variable). Therefore if independent variable increases by 1%, this will result in 11.7% increase in dependent variable. The t value for the hypothecsis 3.955 that CEO duality is a major predictor of financial performance.

## 4. CONCLUSION AND IMPLICATION

The major conclusion of this study is that board size, board independence and CEO duality are among most dominant cg structure and mechanism that affects the performance of banks. In the modern competitive and globalized business age, economic activities are growing up. The success of firms depends on their corporate governance and financial performance. This study has been attempted to analyze corporate governance index and other factors influencing financial performance of Nepalese firms. The result of study confirms that financial performance of Nepalese firms is positively affected with the level of corporate governance.

It has been concluded that corporate governance and corporate financial performance are correlated and Governance in the Company has significant positive impact on its financial performance. This research finding may support decision of company to improve its governance structure. Companies should strive to improve its performance along indicators of good governance – Leadership Ethics, Board Composition & Independence, Executive Compensation, Transparency and Reporting, Stakeholder Engagement, and Compliance with law in true letter and spirit. Companies should understand that improving governance and sustainability performance is as important as improving the financial performance.

The role of CEO and Chairman should be distinct and separated to ensure the balance of power of the two designations as well as to avoid conflict of interest. It is also to avoid a single person in the board to dominant the others in decision making process so to promote fair judgment and reasonable concern. If there is a duality, independent element should be included and such information be disclosed to the public for transparency purpose.

It has been concluded that banks are more prone to risk of failures due to bad corporate governance practices. Regarding the prime role of the board of directors, the primary analysis found that formulation of the long term goals and strategies as the desirable prime role in opinions of respondents.

Most of the banks are seen to make reviews of their corporate governance practices sometimes whenever it is needed. In an attempt to analyze the corporate governance structure and mechanism along with its impact on performance of bank in Nepal, this study has been able to document the significant influence of corporate governance on performance of banks. Since banks are quite different from other corporate entities, the findings of this study are equally important for the promoters of banks, regulators, depositors and many others.

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