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# THE IMPACT OF THE NUMBER OF DIRECTORS ON THE BOARD AND THE NUMBER OF INDEPENDENT DIRECTORS ON THE BOARD ON THE FINANCIAL PERFORMANCE OF LICENSED COMMERCIAL BANKS IN SRI LANKA

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**Abstract**

The Banking Act No. 30 of 1988 in Sri Lanka delineates two primary categories within the banking sector: Licensed Commercial Banks (LCBs) and Licensed Specialized Banks (LSBs). LCBs hold a paramount position, wielding the largest market share of financial system assets and exerting a dominant influence over the industry. Consequently, the stability and effectiveness of LCBs significantly influence the overall health of the Sri Lankan financial system. To ensure sound governance within these pivotal financial institutions, the Central Bank of Sri Lanka (CBSL) introduced Banking Act Direction No. 11 in 2007, establishing specific minimum standards for corporate governance. Section 3(2) of this directive outlines the requisite board composition standards. This paper seeks to delve into whether the number of directors on the board and the number of independent directors on the board has an impact on the financial performance of Licensed Commercial Banks in Sri Lanka. The financial performance of the LCBs was measured using "Return of Assets" and "Return on Equity". This study concludes that the number of directors on the board and the number of independent directors on the board has a strong positive relationship with the financial performance of LCBs.

***Key Words: Sri Lanka, Corporate Governance, Bank, Licensed Commercial Banks, Board of Directors***

## 1. Introduction

Corporate governance represents a fundamental framework that defines and regulates the relationship between a company's stakeholders, such as shareholders, management, customers, financiers, suppliers, the government, and the community (Affes & Jarboui, 2023). It encompasses the system of rules, practices, and processes by which a company is directed and controlled, focusing on transparency, accountability, and fairness. Effective corporate governance ensures that a company operates in the best interests of its stakeholders and in alignment with its organisational goals and societal expectations (Chen, 2021).

The significance of sound corporate governance has grown exponentially in recent years due to high-profile corporate scandals and financial crises that raised concerns about the ethical conduct and decision-making processes within organizations. Consequently, it has become imperative for companies to establish robust corporate governance structures to enhance trust, attract investment, and sustain long-term growth (Grantham, 2020).

In the dynamic landscape of the banking sector, the structure and operations of licensed commercial banks (LCBs) hold paramount importance. Within this sphere, the composition of the board of directors emerges as pivotal determinants that significantly influence the financial performance and overall effectiveness of these financial institutions. The number of directors on the board and the number of independent directors on the board are crucial variables in the governance and decision-making processes of licensed commercial banks in Sri Lanka (Wickremasinghe, 2018).

Licensed commercial banks, as key players in Sri Lanka's financial sector, significantly influence the country's economic trajectory. The composition of their boards, including the number of directors and their qualifications, plays a critical role in shaping strategic decisions, managing risks, and maintaining organizational transparency. Additionally, the presence of independent directors on the board ensures impartial oversight and enhances governance by promoting board independence (Weerasinghe, 2019).

In response to the growing recognition of the significance of corporate governance, regulatory bodies and institutions, such as the Central Bank of Sri Lanka (CBSL), have issued guidelines and directives to ensure sound governance practices within the banking sector (Wickremasinghe,2018). The CBSL, through its regulatory framework, emphasizes the importance of appropriate board composition and independence. These directives set the stage for exploring whether the number of directors on the board and the number of independent directors on the board have a tangible impact on the financial performance of licensed commercial banks in Sri Lanka (Hassan & Athambawa, 2021).

This study aims to explore the complex relationship between board dynamics and financial performance within Sri Lankan licensed commercial banks. By examining the interaction of these factors, the paper seeks to offer valuable insights for regulators, policymakers, and industry practitioners, ultimately contributing to the improvement of corporate governance practices in the Sri Lankan banking sector.

## 2. Literature Review

### 2.1 Board Composition

Section 2(2) of "Banking Act Direction No. 11 of 2007: Corporate Governance for Licensed Commercial Banks in Sri Lanka" offers a thorough understanding of the principle of "board composition." The directive underscores the importance of a well-structured board that achieves a harmonious balance between executive and non-executive directors. Moreover, it highlights the significance of certain non-executive directors embodying independence, thus injecting a robust independent perspective into the decision-making processes. The direction strongly advocates for board composition to encompass a diverse range of skills and experiences, carefully tailored to cater to the specific needs and demands of the bank.

The required board composition for Sri Lankan commercial banks provided in section 3(2) of the directions.

*" Section 3 (2) of the said direction states,*

*1. The number of directors on the board shall not be less than seven (7) and not more than thirteen (13).*
*2. The total period of service of a director other than a director who holds the position of chief executive officer shall not exceed nine years.*
*3. An employee of a bank may be appointed, elected or nominated as a director of the bank (hereinafter referred to as an "executive director") provided that the number of executive directors shall not exceed one-third of the number of directors of the board. In such an event, one of the executive directors shall be the chief executive officer of the bank.*
*4. The board shall have at least three independent non-executive directors or one third of the total number of directors, whichever is higher.A non-executive director shall not be considered independent if he/she:*
*a) has direct and indirect shareholdings of more than 1 per cent of the bank;*
*b) currently has or had during the period of two years immediately preceding his/her appointment as director, any business transactions with the bank as described in Direction 3(7) hereof, exceeding 10 per cent of the regulatory capital of the bank.*
*c) has been employed by the bank during the two-year period immediately preceding the appointment as director;*
*d) has a close relation who is a director or chief executive officer or a member of key management personnel or a material shareholder of the bank or another bank. For this purpose, a "close relation" shall mean the spouse or a financially dependent child;*
*e) represents a specific stakeholder of the bank;*
*f) is an employee or a director or a material shareholder in a company or business organization:*
*I. which currently has a transaction with the bank as defined in Direction 3(7) of these Directions, exceeding 10 per cent of the regulatory capital of the bank, or*
*II. in which any of the other directors of the bank are employed or are directors or are material shareholders; or*
*III. in which any of the other directors of the bank have a transaction as defined in Direction 3(7) of these Directions, exceeding 10 per cent of regulatory capital in the bank;*

*5. In the event an alternate director is appointed to represent an independent director, the person so appointed shall also meet the criteria that applies to the independent director.*
*6. Non-executive directors shall be persons with credible track records and/or have necessary skills and experience to bring an independent judgment to bear on issues of strategy, performance and resources.*

*7. A meeting of the board shall not be duly constituted, although the number of directors required to constitute the quorum at such meeting is present, unless more than one half of the number of directors present at such meeting are non-executive directors.*
*8. The independent non-executive directors shall be expressly identified as such in all corporate communications that disclose the names of directors of the bank. The bank shall disclose the composition of the board, by category of directors, including the names of the chairman, executive directors, non-executive directors and independent non-executive directors in the annual corporate governance report.*
*9. There shall be a formal, considered and transparent procedure for the appointment of new directors to the board. There shall also be procedures in place for the orderly succession of appointments to the board.*
*10. All directors appointed to fill a casual vacancy shall be subject to election by shareholders at the first general meeting after their appointment.*
*11. If a director resigns or is removed from office, the board shall: (a) announce the director's resignation or removal and the reasons for such removal or resignation including but not limited to information relating to the relevant director's disagreement with the bank, if any; and (b) issue a statement confirming whether or not there are any matters that need to be brought to the attention of shareholders.*
*12. A director or an employee of a bank shall not be appointed, elected or nominated as a director of another bank except where such bank is a subsidiary company or an associate company of the first mentioned bank."*

A literature review on the impact of the number of directors and independent directors on the board on the financial performance of licensed commercial banks can provide insights into the various perspectives and findings in this area.

A study by Ali and Bursary examined the relationship between board size, independence, and firm performance in the banking sector. They found that both the size and independence of the board positively influence financial performance, with factors like the number of independent directors contributing to better governance practices and improved decision-making efficiency (Ali & Bursary, 2023). Hamlin (2023) explored the impact of board size on decision-making in their study. They argue that an optimal board size is essential to facilitate effective decision-making and ensure swift actions that can enhance financial performance. Sharma and Kalyani (2023) present the agency theory perspective, indicating that the number of directors on the board can affect agency costs. They propose that a larger board might lead to higher agency costs, potentially impacting financial performance due to coordination challenges and conflicts of interest.
Similarly, Goel et al. (2022) explored the impact of board composition in the Indian context, finding that a diverse board—both in terms of expertise and independence—leads to stronger financial outcomes by enhancing strategic oversight and risk management (Goel et al., 2022). Both

studies underscore the importance of optimal board structure in enhancing corporate governance and ensuring sustained financial success.

Recent studies have continued to explore the relationship between board diversity and financial performance, reaffirming the positive impact of diversity in enhancing decision-making and strategic planning. For example, Kweh et al. (2022) found that board diversity, particularly in terms of skills, gender, and experience, significantly contributes to financial performance by promoting innovative thinking and improving governance outcomes. Their study emphasizes that diverse boards are better equipped to address complex challenges and market demands.

Similarly, recent research by Mahmood et al. (2021) highlights the importance of independent directors in enhancing governance and financial performance through effective risk management and oversight. Independent directors contribute to reducing conflicts of interest and improving accountability within the board, leading to better financial outcomes for the organization.

Recent studies continue to build upon the foundational ideas presented by Freeman (1984) regarding stakeholder theory and its impact on board composition. For instance, a 2023 study by Kassinis et al. emphasizes that aligning board composition with the interests of diverse stakeholders, such as employees, customers, and the community, can significantly enhance a firm's financial performance by improving its responsiveness to stakeholder demands. They highlight that boards with broader representation of stakeholder interests tend to make more sustainable and strategic decisions, contributing to long-term financial success.

In a similar vein, recent research by Baatwah et al. (2022) explores the role of regulatory factors in shaping board composition. They found that compliance with regulatory guidelines on the number and qualifications of directors helps improve governance effectiveness and can positively impact financial performance, particularly in highly regulated industries like banking.

Altunbas et al. (2021) explores the effect of the economic environment on board structure and effectiveness. Economic conditions can influence the number and types of directors on the board, subsequently affecting financial performance.

A comprehensive understanding of these studies can shed light on the relationship between the number of directors on the board and the financial performance of licensed commercial banks, informing future research and industry practices.

The structure of a board, known as board composition, stands as a critical pillar in the realm of corporate governance. It primarily pertains to the proportion of executive and non-executive directors within the board. The composition of the board is significantly shaped by two fundamental theories in corporate governance: agency theory and stewardship theory. When a

board is dominated by non-executive directors, it aligns more with the principles of agency theory (Heenatigala, 2011).

Recent studies continue to investigate the balance between executive and non-executive directors on corporate boards, offering varying perspectives. For example, Zaman et al. (2022) emphasize the importance of non-executive directors, asserting that their independence from management enhances board oversight and leads to better governance outcomes. This aligns with agency theory, which suggests that non-executive directors can mitigate conflicts of interest and improve financial performance through enhanced accountability.

In contrast, Abdullah and Ku Ismail (2020) explore the relevance of stewardship theory in modern corporate governance, supporting the idea that executive directors, being more deeply involved in the firm's operations, can make more informed strategic decisions. They argue that executive directors, acting as stewards, are committed to the long-term success of the firm, thereby contributing to improved profitability.

Recent studies continue to validate the importance of board composition, particularly with a focus on non-executive directors. For example, Zainal et al. (2021) argue that a majority of non-executive directors enhances board independence and strengthens oversight, aligning with the principles of agency theory. Their research indicates that non-executive directors, due to their detachment from day-to-day operations, contribute objectivity and impartiality, which improves governance and risk management.

Meanwhile, Hamid et al. (2020) emphasize the role of executive directors in contributing specialized knowledge and operational expertise. Executive directors' intimate understanding of the business equips the board with valuable insights necessary for making informed strategic decisions, highlighting the importance of a balanced board composition.

Cadbury (1992) emphasized that the core duty of non-executive directors lies in monitoring. However, over time, these directors develop personal relationships and bonds with the executive directors, potentially diminishing their effectiveness as monitors as their tenure extends. If the presence of non-executive members on the board indeed enhances monitoring effectiveness, it logically follows that the company's overall performance would experience a positive impact (Heenatigala, 2011).

Hassan and Athambawa (2021) conducted a study on "Corporate Governance and Financial Performance of Commercial Banks in Sri Lanka". The study gathered research data from annual reports of twelve domestic commercial banks from 2012 to 2019. According to the results of the correlation analysis, there is a negative relationship between board size and ROA and ROE. There is also a negative association between independent directors on the Board and ROA and ROE.

Chaarani et al (2022) examined the "Impact of Corporate Governance on the Financial Performance of the Banking Sector in the MENA (Middle Eastern and North African) Region: An Immunity Test of Banks for COVID-19".The results revealed that the presence of independent members on the board, high ownership concentration, lack of political pressure on board members, and strong legal protection, had positive impact on bank financial performance of banks. Corporate

governance mechanisms, such as performance-based compensation, the presence of women on boards, moderate size of the board, and anti-takeover mechanisms had no significant impact on bank performance during the crisis period. An effective internal and external corporate governance mechanism could improve the financial performance of banks in MENA countries in times of pandemics and crises.

In Dubai, Elbahar (2019) has conducted a research on "Board of director's characteristics and bank performance in GCC region". The study considered "bank performance measured by the proxy variable ROE and ROA as dependent variables and twelve (12) independent variables classified into two groups. The first group is board characteristics variables: percentage of non-executive directors, gender diversity, board size, CEO-Turnover, existence of BOD committees such as audit committee, risk committee, credit & investment committee and Sharia Committee and number of political members". The second group is "control variables: bank type (Islamic and conventional), ownership structure (government ownership), firm size". The results provided that the "existence of female members on the board of directors is significantly associated with better performance at 1% significance level". Furthermore, "the association between board size and performance is positive and significant at 1% significance level". Regarding the "existence of political members on the board and bank performance, study concluded that the change in performance cannot be explained by the change in political members' number".

Kandasamy and Puwanenthiren (2018) studied on "Board Governance and Firm Performance: The Sri Lankan Case,". A 150-firm sample from the Colombo Stock Exchange (CSE) was used in this study to analyze board composition and firm performance. The secondary data for independent variable was obtained in 2016, giving the 2017 performance data a one-year lag. Female participants, board meetings, and CEO duality are not substantially linked with any of the firm performance indicators, according to the data. Board size and board independence have a major beneficial influence in the performance measures (i.e., ROA and ROE).

Isik and Ince (2016) investigated the impact of "board size" and "board composition" on financial performance on thirty commercial banks in Turkey for the period of 2008 to 2012.They have measured the financial performance of banks using "Operating Retune on Assets (OROA) and "Return on Assets"( ROA).Even though they have come up with a positive correlation between the "board size" and the "bank performance", their findings clearly stated that there is no significant relationship between the "board composition" and bank "financial performance". That is, the number of "independent non-executive directors" has no bearing on the banks' financial performance.

## 3. Research Methodology

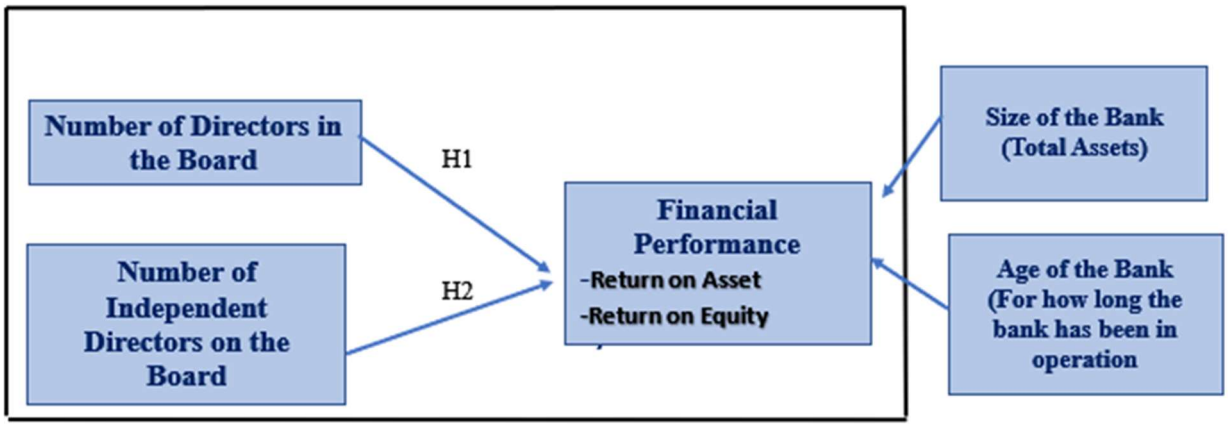
The purpose of this research is to examine the influence of board size and the presence of independent directors on the financial performance of Licensed Commercial Banks (LCBs) in Sri

Lanka. This study builds upon established research methodologies in this field. Many previous studies investigating these relationships have employed a positivist paradigm, adopting a deductive approach and utilizing quantitative techniques to analyze secondary data. The researcher intends to adopt a similar methodology for this study.

The study explores the connection between corporate governance practices and the financial outcomes of LCBs in Sri Lanka. As of September 30, 2023, the population for this study includes all twenty four (24) LCBs operating in Sri Lanka (Appendix I) (www.cbsl.gov.lk, 2021). However, the researcher excluded eleven (11) LCBs that are branch offices of foreign banks, leaving a total of thirteen (13) LCBs to be analyzed in this study.

The Corporate Governance Report, signed by the Chief Compliance Officer of the Licensed Commercial Bank (LCB), along with the bank's Audited Financial Statements, signed by the Chief Financial Officer, will be reviewed to gather secondary data for this study. These documents are expected to provide essential information on governance practices and financial performance metrics, which are crucial for the analysis.

3.1 Conceptual Framework




Research Hypotheses

(H1): There exists a Correlation Between "Board Composition" and the "Financial Performance" of Licensed Commercial Banks.

The term "board composition" pertains to the count of directors constituting the board. The number of directors on the board is linked to the financial performance of banks.

(H2):There is a relationship between the “Board Independence” and “Financial Performance” of Licensed Commercial Banks.

Board independence refers to the number of independent directors on the board. According to the Banking Act Direction No. 7 of 2011 on Corporate Governance for Licensed Commercial Banks, the board should have at least three independent non-executive directors or one third of the total number of directors, whichever is higher (www.cbsl.gov.lk). There is a relationship between number of board independent directors and financial performance of banks.

## 4. Data Analysis

### 4.1 Regression Analysis

This study is aimed to explore the Impact of the number of directors in the board (DIR), the number of independent directors on the board (IDR) on the performance of the bank where the Return on asset (ROA) and Return on equity (ROE) is taken as the proxy to measure the bank performance. For this evaluation equation 1 can be formed.

$PER_{it} = \beta o + \beta_1 (DIR_{it}) + \beta_2 (IDR_{it}) + \varepsilon_{it}$ …… (1)

Whereas

PER = Performance represented by ROA and ROE……(Dependent Variable)

DIR = Number of Directors on the Board…….(Independent Variable )

IDR = Number of Independent Directors on the board (Independent Variable)

ε = error term

### 4.2 Descriptive Analysis of secondary data

#### 4.2.1 Behaviour of variables used in the study

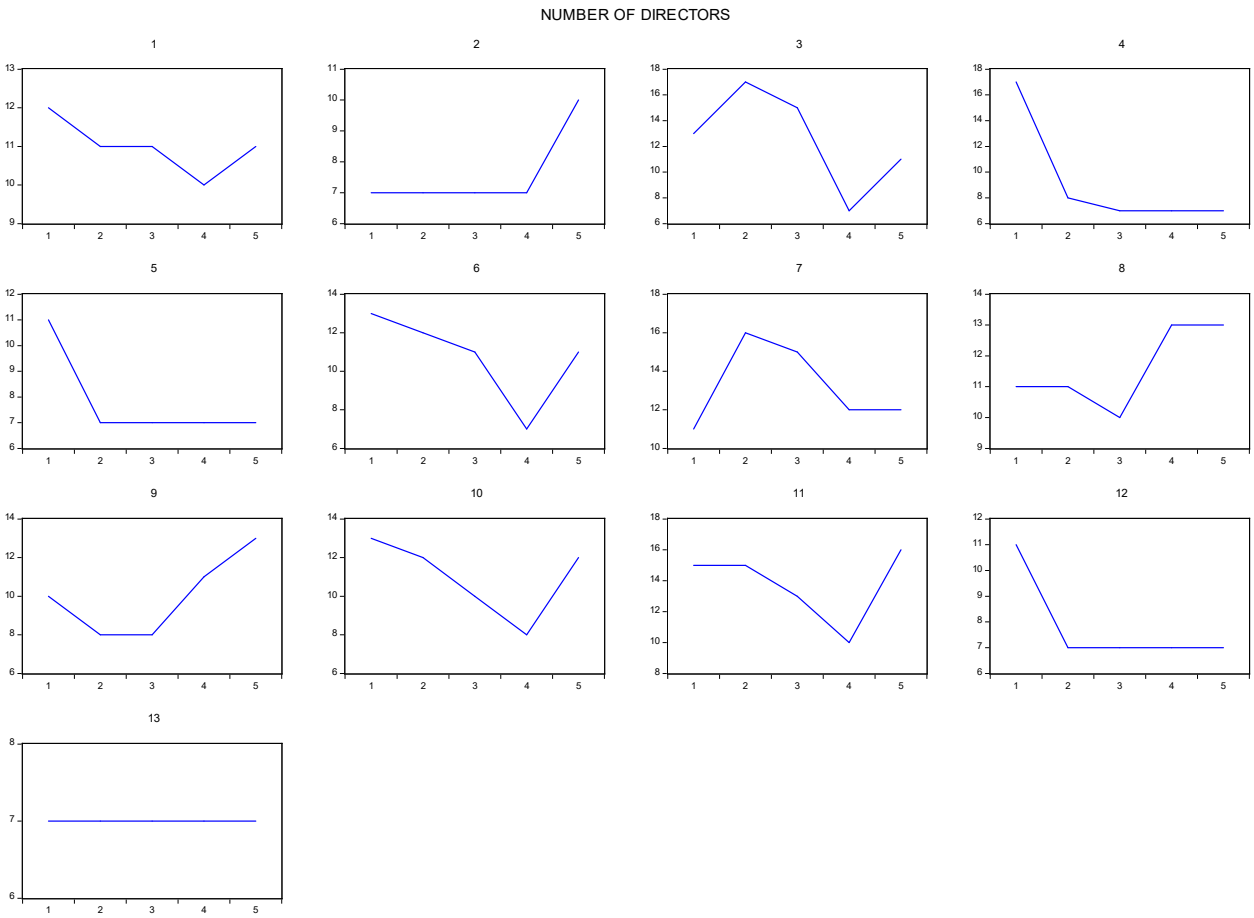



***Figure 4.1 – Observed behavior of number of directors from 2017 to 2021***

The number of directors in all the considered banks were within the Central Bank stipulated limit and some show fluctuations within that limit.

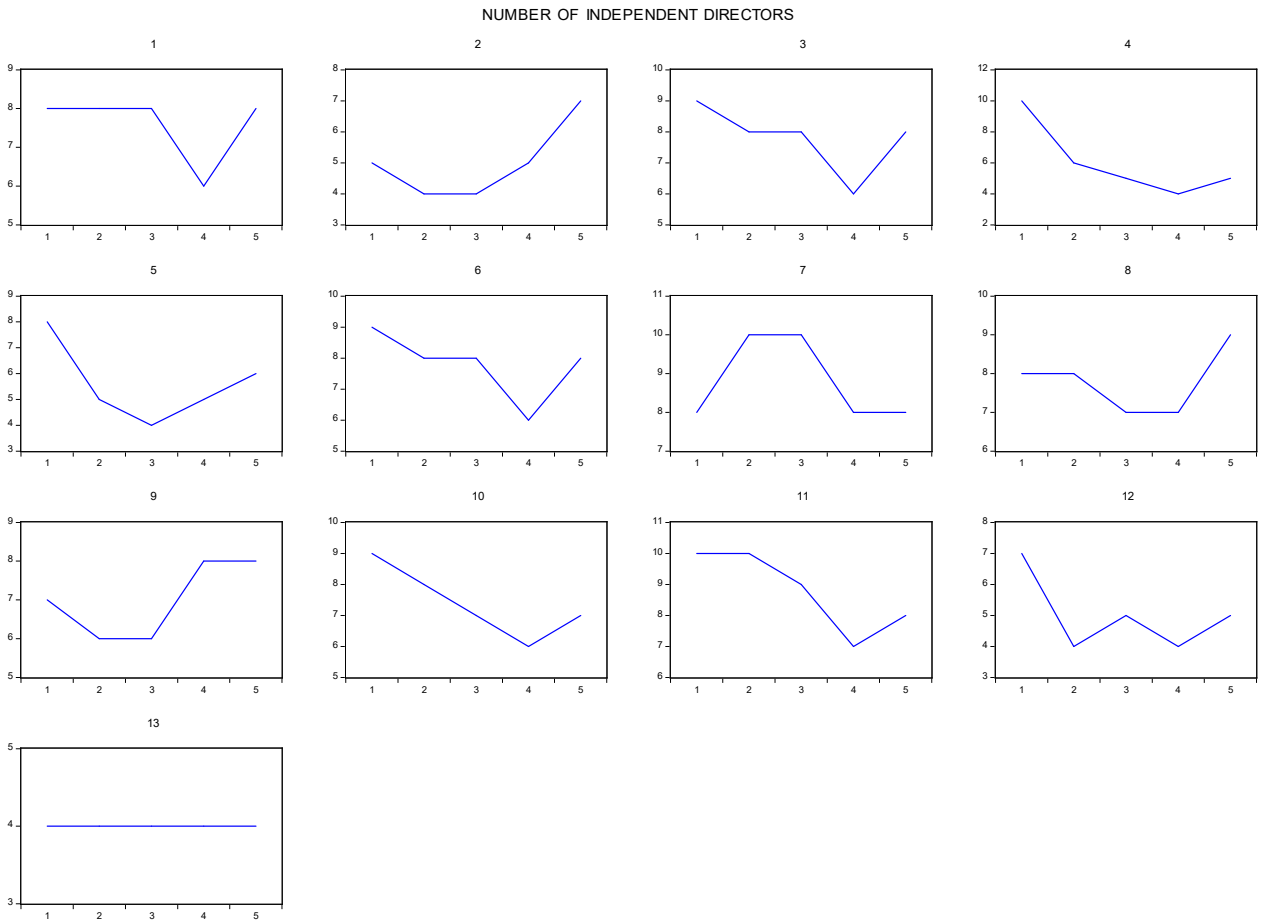



***Figure 4.2 – Observed behavior of No. of independent directors on the board from 2017 to 2021***

The number of independent directors in all the banks under review consistently adhered to the limits set by the Central Bank. While these banks maintained compliance with the regulatory requirements, the number of independent directors exhibited some fluctuations within the permissible range. This variation suggests that although the banks ensured adherence to the stipulated guidelines, they also adjusted the composition of their boards to align with changing governance needs, strategic priorities, and evolving regulatory expectations.

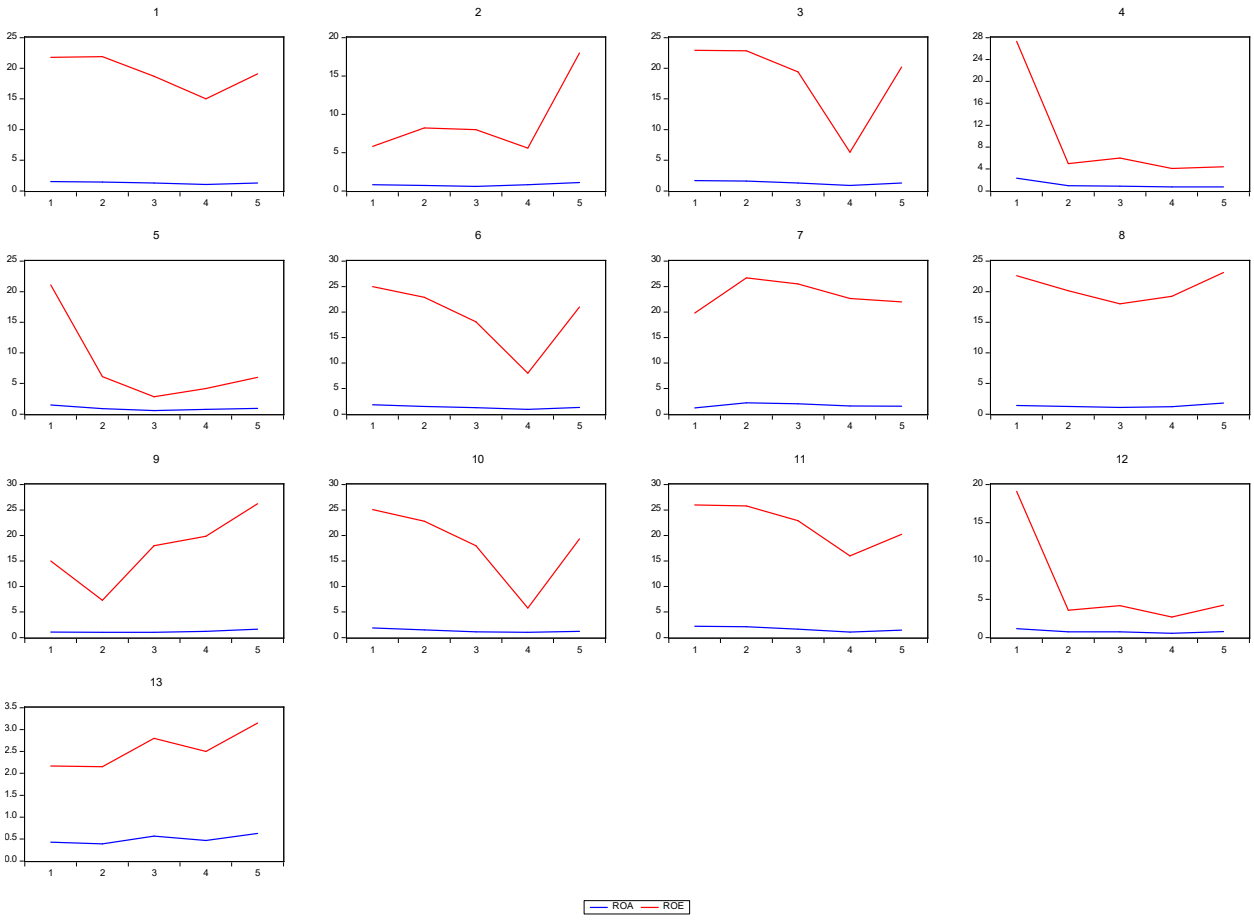



***Figure 4.3 – Observed behavior of return on assets and return on equity from 2017 to 2021***

Return on assets and return on equity shows fluctuations and yet growth has shown during the last year (figure 4.3).

4.2.2 Behavior of Return on assets (ROA) with independent variables

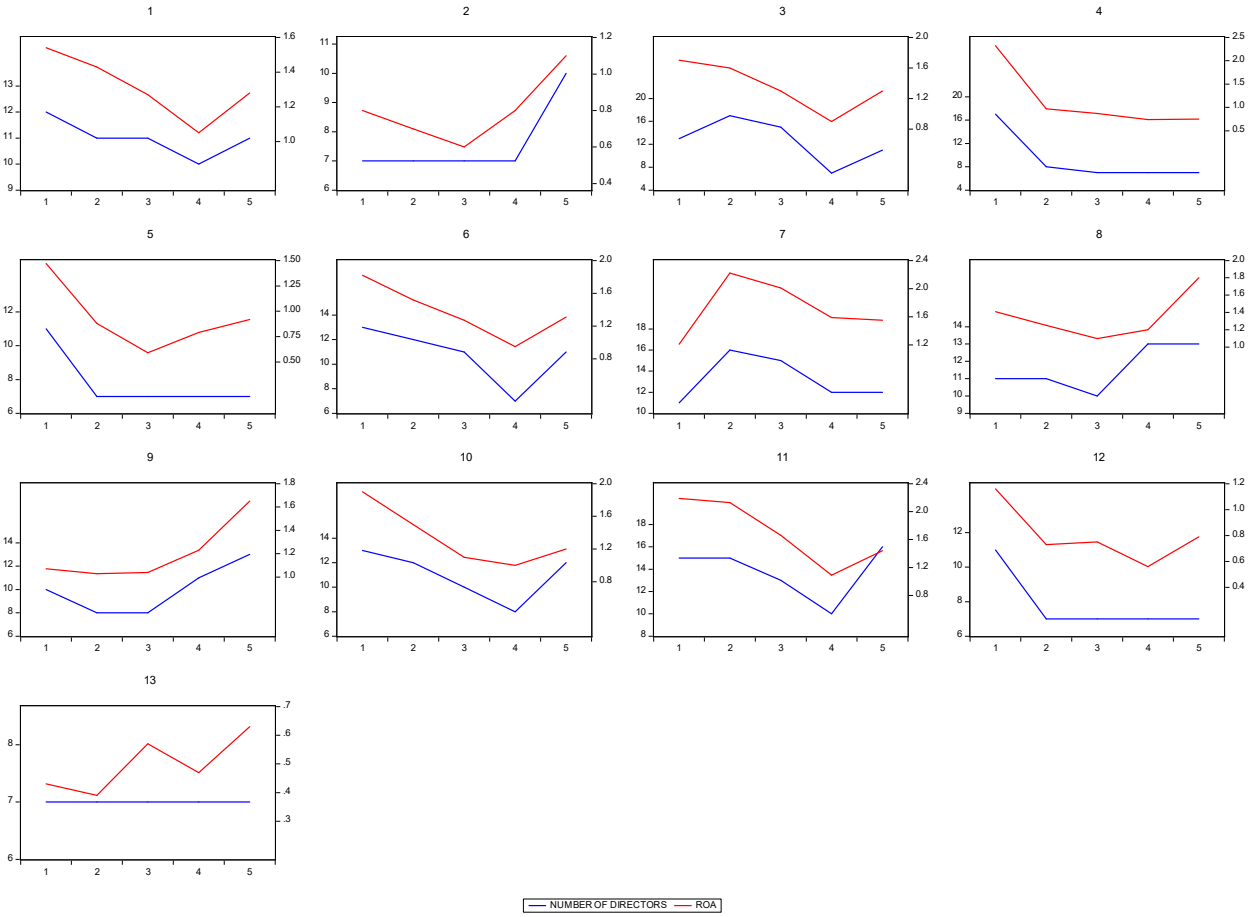



**Figure 4.4 – Behavior of ROA and number of directors on the board 2017 – 2021.**
(Authors finding 2023)

Left Y represents Number of directors (DIR) and right Y represents ROA. Both shows fluctuating trend and close correlations by look.

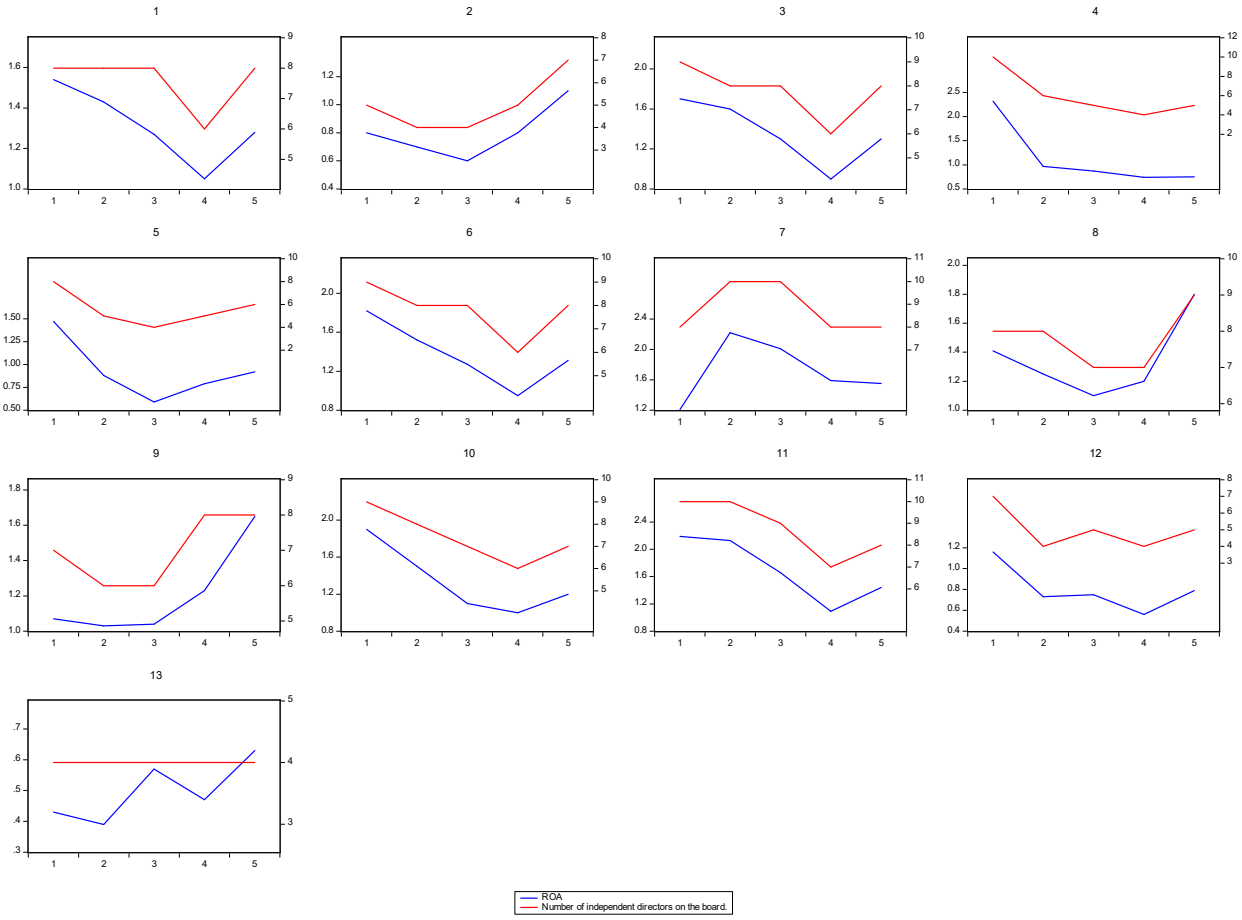



**Figure 4.5 – Behavior of ROA and number of independent directors on the board 2017 - 2021.**

Left Y represents number of independent directors (IDR) held during the year and right Y represents ROA. It is seen that there is positive correlation between two variables.

4.2.3 Behaviour of Return on equity (ROE) with independent variables.

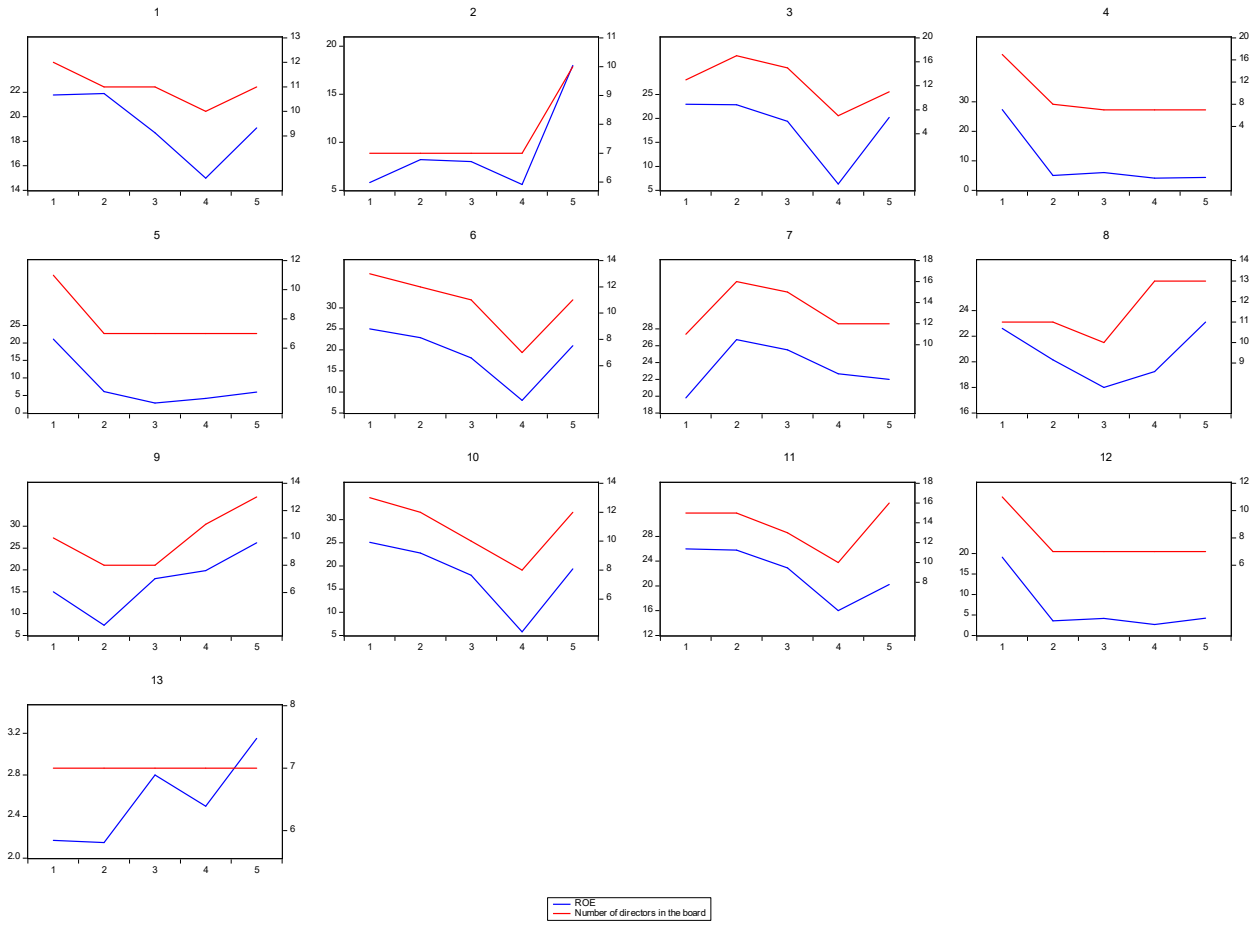



**Figure 4.6 – Behavior of ROE with number of directors in the board 2017-2021.**

Left Y represents DIR and right Y represents ROE. Both shows increasing trend and close positive correlations by look.

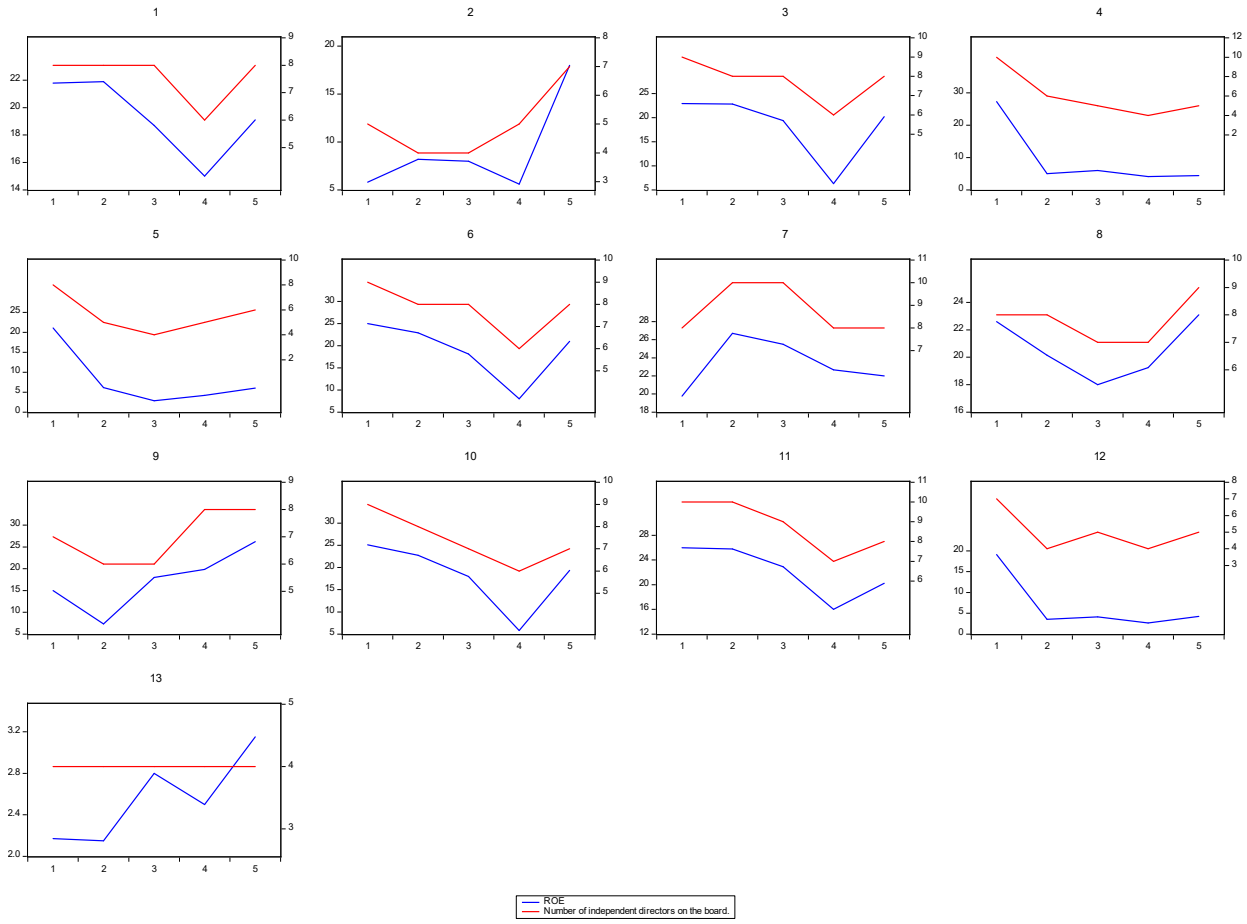



**Figure 4.7 – Behavior of ROE with number of independent directors on the board 2017-2021**

Left Y represents IDR and right Y represents ROE. Both shows increasing trend and close positive correlations by look.

4.3 Panel Data Analysis

$PER_{it} = \beta_o + \beta_1 (DIR_{it}) + \beta_2 (IDR_{it}) + \varepsilon_{it}$ ..... (1)

PER*it*: This represents the dependent variable performance of the bank *i* at time *t*.

$\beta_1, \beta_2$ = are the coefficients associated with the independent variables DIR*it*, IDR*it*, respectively. These coefficients measure the change in the dependent variable for a one-unit change in the corresponding independent variable, holding other variables constant.

$\varepsilon_{it}$: This is the error term, capturing unobserved factors or random shocks that affect the dependent variable but are not explicitly included in the model.

4.1 Panel Data Analysis without Control Variables

When conducting panel data analysis without control variables, the regression equation simplifies, focusing solely on the relationship between the dependent variable and the primary independent

variables. In this simplified model, the focus is solely on understanding the relationship between the dependent variable and the primary independent variable across entities and time periods. Without control variables, the analysis aims to identify the association or impact of $X_{it}$ on $Y_{it}$ without considering additional factors.

4.2 Fixed Effect Model

Estimating this model involves capturing the within-entity variation over time and obtaining coefficients that reflect the impact of the independent variables on the dependent variable, net of the individual-specific fixed effects.

$PER_{it} = \beta o + \beta_1 DIR_{it} + \beta_2 IDR_{it} + \alpha_i + \varepsilon_{it}$ …… (2)

$\alpha_i$ is the individual-specific fixed effect for entity *i*. This term captures time-invariant characteristics or factors associated with each individual or entity that are not observed but are constant over time.

**Table 4.1 – Estimated Regression Coefficients (Fixed Effect Model)**

Dependent Variable: ROA

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| DIR | 0.040214 | 0.013309 | 3.021597 | 0.0040 |
| IDR | 0.195125 | 0.024710 | 7.896446 | 0.0000 |
| C | -0.548819 | 0.096992 | -5.658417 | 0.0000 |

| | |
|---|---|
| R-squared | 0.943013 |
| Adjusted R-squared | 0.927056 |
| S.E. of regression | 0.125302 |
| F-statistic | 59.09915 |
| Prob(F-statistic) | 0.000000 |

**Table 4.2 – Estimated Regression Coefficients (fixed effect model)**

Dependent Variable: ROE

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| DIR | 1.113608 | 0.255004 | 4.367013 | 0.0001 |
| IDR | 2.579589 | 0.473460 | 5.448379 | 0.0000 |
| C | -14.07961 | 1.858391 | -7.576233 | 0.0000 |

| | |
|---|---|
| R-squared | 0.937528 |

| | |
|---|---|
| Adjusted R-squared | 0.920036 |
| S.E. of regression | 2.400826 |
| F-statistic | 53.59720 |
| Prob(F-statistic) | 0.000000 |

The applied model

$PER_{it} = \beta o + \beta_1 DIR_{it} + \beta_2 IDR_{it}$ …… (3)

$PER_{it} = \beta o + \beta_1 DIR_{it} + \beta_2 IDR_{it}$ …… (3)

ROA = -0.55 + 0.04 DIR + 0.195 IDR ……(4)

ROE = -14.08 + 1.11 DIR + 2.58 IDR ……(5)

Random Effect Model

In the random effects model, $\alpha_i$ is treated as a random variable. The assumption is that $\alpha_i$ has a mean of zero and is uncorrelated with the independent variables. The random effects model allows for the estimation of the average effect of the independent variable across entities, capturing both within-entity and between-entity variations.

**Table 4.3– Estimated Regression Coefficients (Random Effect Model)**

Dependent Variable: ROA

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| DIR | 0.037193 | 0.012319 | 3.019088 | 0.0037 |
| IDR | 0.185668 | 0.020203 | 9.190329 | 0.0000 |
| C | -0.453360 | 0.064646 | -7.012997 | 0.0000 |
| R-squared | 0.918504 | | | |
| Adjusted R-squared | 0.915875 | | | |
| S.E. of regression | 0.125775 | | | |
| F-statistic | 349.3865 | | | |
| Prob(F-statistic) | 0.000000 | | | |

**Table 4.4 – Estimated regression coefficients (Random Effect Model)**

Dependent Variable: ROA

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| DIR | 0.904327 | 0.239052 | 3.782973 | 0.0004 |
| IDR | 2.975099 | 0.396622 | 7.501092 | 0.0000 |
| C | -14.62761 | 1.311982 | -11.14925 | 0.0000 |

| | |
|---|---|
| R-squared | 0.895124 |
| Adjusted R-squared | 0.891741 |
| S.E. of regression | 2.468823 |
| F-statistic | 264.5882 |
| Prob(F-statistic) | 0.000000 |

The applied model

$PER_{it} = \beta o + \beta_1 DIR_{it} + \beta_2 IDR_{it}$ .. …… (3)

ROA = -0.45 + 0.04 DIR + 0.19 IDR ……...……(6)

ROE = -14.63 + 0.90 DIR + 2.98 IDR ……..……(7)

4.3 Selecting Fixed Effect or Random Effect for Further Analysis

**Hausman test was** conducted to formally test whether the fixed effects model or random effects model is more appropriate (Baltagi, 2021). The Hausman test examines whether the individual-specific effects are correlated with the independent variables (Baltagi, 2021).

**Table 4.5 Correlated Random Effects - Hausman Test**

**Correlated Random Effects - Hausman Test**

| Test Summary | Chi-Sq. Statistic | Chi-Sq. d.f. | Prob. |
|---|---|---|---|
| Cross-section random | 5.561721 | 2 | 0.0620 |

The null hypothesis of the Hausman test is:

$H_0$ = random effects are consistent and efficient.

Since the p>.05, the null hypothesis is failed to reject. Therefore, the random effect model is accepted for further analysis.

4.4 Hypothesis Testing using Panel Data Regression Analysis with Random Effect Model

The hypothesis made in this study were;

$H_1$ : There exists a Correlation Between "Board Composition" and the "Financial Performance" of Licensed Commercial Banks.

$H_2$ : There is a relationship between the “Board Independence” and “Financial Performance” of Licensed Commercial Banks.

Return on Assets as the dependent variable

The regression equations for the hypothesis testing is;

$PERit = \beta o + \beta 1 DIRit + \beta 2\ IDRit + \varepsilon_{it}$ …… (3)

$ROA_{it} = \beta o + \beta_1 DIR_{it} + \beta_2\ IDR_{it} + \varepsilon_{it}$ …… (8)

After inclusion of control variables,

$ROA_{it} = \beta o + \beta_1 DIR_{it} + \beta_2\ IDR_{it} + \beta_5\ ASSETS_{it} + \beta_6\ AGE_{it} + \varepsilon_{it}$…… (9)

Whereas

PER = Performance represented by ROA and ROE (Dependent Variable)
DIR = Number of Directors on the Board (Independent Variable)
IDR = Number of Independent Directors on the Board (Independent Variable)
ε = error term
ASSETS = Total assets of the bank (control variable).
AGE = Age of the bank (control variable).

To test the hypothesis, the equation (8) is run and to consider the effect of control variables, the equation (9) was run. The results are depicted in the table 4.6.

**Table 4.6 Regression coefficient (Dependent variable: ROA) – with control variables**

Dependent Variable: ROA

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| C | -0.286712 | 0.102251 | -2.804010 | 0.0068 |
| DIR | 0.037231 | 0.012389 | 3.005140 | 0.0039 |
| IDR | 0.195438 | 0.020635 | 9.471229 | 0.0000 |
| LNASSET | -0.040244 | 0.020836 | -1.931421 | 0.0582 |
| AGE | 0.000251 | 0.000750 | 0.334569 | 0.7391 |

Weighted Statistics

| | |
|---|---|
| R-squared | 0.926516 |
| Adjusted R-squared | 0.921617 |
| S.E. of regression | 0.122748 |
| F-statistic | 189.1263 |
| Prob(F-statistic) | 0.000000 |

Overall Model Fit:
R-squared explains the proportion of variance in the dependent variable explained by the independent variables. Adjusted R squared was 92% indicating a better fit.

Specific Interpretations after inclusion of control variables.
$ROA_{it} = \beta o + \beta_1 DIR_{it} + \beta_2 IDR_{it} + \beta_5 ASSETS_{it} + \beta_6 AGE_{it} + \varepsilon_{it}$…… (9)
ROA = -0.29 + 0.04DIR + 0.195 IDR -0.04lnAssets +0.0003 AGE ……(10)

- DIR has a positive coefficient (0.045) and a significant p-value (<0.05). This suggests a strong positive impact of number of directors on the board (DIR) on the return on assets (ROA) with control variables.

- IDR has a positive coefficient (0.195) and a significant p-value (<0.05). This indicates a significant positive impact of number of independent directors on the board (IDR) on the return of the assets (ROA) with control variables.

- The impact of control variables the total assets (lnAssets) and age of the bank statistically insignificant (p>0.05).

Therefore, it can be concluded that the Number of directors on the board (DIR), number of the independent directors on the board (IDR), have positive and statistically significant impact on the financial performance of the banks when the financial performance is measured using return on assets (ROA).
Return on Equity as the dependent variable
The regression equations for the hypothesis testing is;
$ROE_{it} = \beta o + \beta_1 DIR_{it} + \beta_2 IDR_{it} + \varepsilon_{it}$ …… …… (11)
After inclusion of control variables,
$ROE_{it} = \beta o + \beta_1 DIR_{it} + \beta_2 IDR_{it} + \beta_5 ASSETS_{it} + \beta_6 AGE_{it} + \varepsilon_{it}$……. (12)
Whereas
PER = Performance represented by ROE (Dependent Variable)
DIR = Number of Directors on the Board (Independent Variable)
ε = error term
ASSETS = Total assets of the bank (control variable).
AGE = Age of the bank (control variable).

To test the hypothesis, the equation (12) is run. The results are depicted in the table 4.7.
$ROE_{it} = \beta o + \beta_1 DIR_{it} + \beta_2 IDR_{it} + \beta_5 ASSETS_{it} + \beta_6 AGE_{it} + \varepsilon_{it}$ ……. (12)

**Table 4.7 Regression Coefficient (Dependent Variable: ROE) – with control variables**

Dependent Variable: ROE

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| C | -14.75725 | 2.229268 | -6.619774 | 0.0000 |
| DIR | 0.894157 | 0.246397 | 3.628927 | 0.0006 |
| IDR | 2.990673 | 0.415569 | 7.196578 | 0.0000 |
| LNASSET | 0.037008 | 0.449002 | 0.082423 | 0.9346 |
| AGE | -0.002211 | 0.016337 | -0.135358 | 0.8928 |
| R-squared | 0.895871 | | | |
| Adjusted R-squared | 0.888929 | | | |
| S.E. of regression | 2.516820 | | | |
| F-statistic | 129.0526 | | | |
| Prob(F-statistic) | 0.000000 | | | |

ROE = -14.76 + 0.89DIR + 2.99 IDR + 0.04 ASSETS -0.007 AGE …… (13)

- DIR has a positive coefficient (0.89) and a significant p-value (<0.05). This suggests a strong positive impact of number of directors on the board (DIR) on the return on equity (ROE) with control variables.
- IDR has a positive coefficient (2.99) and a significant p-value (<0.05). This indicates a significant positive impact of number of independent directors on the board (IDR) on the return of the equity (ROE) with control variables.
- The impact of control variables the total assets (lnAssets) and age of the bank statistically insignificant (p>0.05).

Therefore, it can be concluded that the Number of directors on the board (DIR), number of the independent directors on the board (IDR) have positive and statistically significant impact on the financial performance of the banks when the financial performance is measured using return on equity (ROE).

4.5 Summary of Results

**Table 4.8 Summary of Results – Impact on Return on Assets**

| Specific Objective | Hypothesis | Beta Coefficient | p - value | Status |
|---|---|---|---|---|
| To investigate how the number of the directors of board | There is a strong positive relationship between the number | 0.04 | 0.0006 | Accepted |

| | | | | |
|---|---|---|---|---|
| impacts the financial performance of Licensed Commercial Banks in Sri Lanka. | of directors on the board and Financial Performance of Licensed Commercial Banks in Sri Lanka. | | | |
| To determine and evaluate whether the number of independent directors of the bank has a significance on the financial performance of Licensed Commercial Banks in Sri Lanka. | There is a strong positive relationship between the number of independent directors on the board and Financial Performance of Licensed Commercial Banks in Sri Lanka. | 0.195 | 0.000 | Accepted |

**Table 4.30 Summary of results – impact on Return on Equity**

| Specific Objective | Hypothesis | Beta Coefficient | p - value | Status |
|---|---|---|---|---|
| To investigate how the number of the directors of board impacts the financial performance of Licensed Commercial Banks in Sri Lanka | There is a strong positive relationship between the number of directors on the board and Financial Performance of Licensed Commercial Banks in Sri Lanka. | 0.89 | 0.0006 | Accepted |
| To determine and evaluate whether the number of independent directors of the bank has a significance on the financial performance of Licensed | There is a strong positive relationship between the number of independent directors on the board and Financial Performance of Licensed | 2.99 | 0.0000 | Accepted |

| | | | | |
|---|---|---|---|---|
| Commercial Banks in Sri Lanka | Commercial Banks in Sri Lanka. | | | |

## 5. Conclusion

In conclusion, the findings of this study indicate that both the number of directors on the board (DIR) and the number of independent directors (IDR) positively and significantly influence the financial performance of banks, specifically when measured by return on equity (ROE). This suggests that larger boards, along with a higher proportion of independent directors, contribute to more effective oversight, enhanced decision-making, and improved strategic direction, all of which drive financial success. The presence of independent directors likely enhances governance by providing objective evaluations of management performance, reducing agency costs, and ensuring that the interests of shareholders are prioritized.

Moreover, the positive impact of board size suggests that a larger pool of expertise and diverse perspectives can lead to more innovative solutions and better risk management practices. These results align with previous research that emphasizes the importance of strong corporate governance in enhancing financial outcomes, particularly in the banking sector, where effective governance is critical for stability and profitability. Therefore, the study reinforces the view that optimizing board composition, both in terms of size and independence, is crucial for improving financial performance in the banking industry.

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