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Athula Sumith Preethi Gardiya Manawaduge
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CORPORATE GOVERNANCE PRACTICES AND THEIR IMPACTS ON CORPORATE PERFORMANCE IN AN EMERGING MARKET: THE CASE OF SRI LANKA

A thesis submitted in fulfilment of the requirements for the award of the degree

Doctor of Philosophy

from

UNIVERSITY OF WOLLONGONG

by

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School of Accounting and Finance

2012

Certification

I, Athula Sumith Preethi Gardiya Manawaduge, declare that this thesis, submitted in fulfilment of the requirements for the award of Doctor of Philosophy, in the School of Accounting and Finance, University of Wollongong, is wholly my own work unless otherwise referenced or acknowledged. The document has not been submitted for qualifications at any other academic institution.

Athula Sumith Preethi Gardiya Manawaduge
March 2012

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List of Abbreviations

AATSL	Association of Accounting Technicians and Sri Lanka
AC	Audit Committee
ACC	Accountants
ACCA	Association of Certified Chartered Accountants
ACD	Academics
ACP	Audit Committee Procedure
ADB	Asian Development Bank
AGM	Annual General Meeting
AR	Annual Report
ASC	Accounting Standards Committee
AUSC	Auditing standards committee
Av	Average
BER	Board Effective Rating
BPE	Board Procedure and Effectiveness
BSI	Board Structure and Independence
CBA	Colombo Brokers Association
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CGBP	Corporate Governance Best Practices
CGI	Corporate Governance Index
CGQ	Corporate Governance Quotient
CGS	Corporate Governance Score
CIMA	Chartered Institute of Management Accountants
CLSA	Credit Lyonnais Securities Asia
CMASL	Society of Certified Management Accountants of Sri Lanka
CSE	Colombo Stock Exchange
CSs	Controlling Shareholders
DR	Disclosure Reliability
DRP	Directors' Remuneration Procedure
DS	Disclosure Substance
EDs	Executive Directors
EPS	Earnings Per Share
F - Com	Fraction of Shares Owned by Corporate Entities
F - Ind	Fraction of Shares Owned by Individuals
FB	Family Based Company
FDI	Foreign Direct Investment
GATO	Government Audit and Tax Officers
GMI	Governance Metrics International
GPM	Government Policy Makers
HERF	Herfindahl Index
IAP	Independent Audit Professionals
ICASL	Institute of Chartered Accountants of Sri Lanka
IFRS	International Financial Reporting Standards
IIA	Institute of Internal Auditors
IMF	International Monetary Fund
INV	Investors
IPFDA	Institute of Public Finance and Development Accountancy
ISS	Institutional Shareholder Services

JCJ	Japan Corporate Governance
LFO	Less Foreign Owned
LN - Age	Log Age
LN - T sal	Log Total Sales
LN- TA	Log Total Assets
MBR	Market to Book Value Ratio
NC	Nomination Committee
NEDs	Non-Executive Directors
NFB	Non-Family Based Company
NYSE	New York Securities Exchange
OC	Ownership Concentration
OCT	Over-the-counter Market.
OECD	Organization for Economic Co-operation and Development
OS	Ownership Structure
OSIRIS	Bureau Van Dijk's OSIRIS Database
RC	Remuneration Committee
ROA	Return on Assets
ROC	Registrar of Companies
ROE	Return on Equity
RPTs	Related Party Transactions
S&P	Standard and Poor
SBE	Specified Business Enterprises
SD	Standard Deviation
SEC	Securities and Exchange Commission
SFO	Substantial Foreign Ownership
SH 1	Largest Shareholder
SH 2	First Two Largest Shareholders
SH 3	First Three Largest Shareholders
SH 5	First Five Largest Shareholders
SH 10	First Ten Largest Shareholders
SLAASMB	Sri Lanka Accounting and Auditing Standards Monitoring Board
SLAS	Sri Lanka Accounting Standards
SLAuS	Sri Lanka Auditing Standards
SLCGC	Sri Lankan Corporate Governance Code
SME	Small and Medium Enterprises
SR	Shareholders' Rights
TCL	The Corporate Library
TD/TA	Total Debt to Total Assets
TQ	Tobin's Q
UITF	Urgent Issues Task Force
UK	United Kingdom
USA	United States of America
VIF	Variance Inflation Factors

Abstract

Many corporate governance practices and reforms in emerging markets are based on corporate governance practices and systems of developed markets, but fail to recognize their suitability and compatibility to these markets. In Sri Lanka, most corporate governance practices are developed based on British practices and they are largely recommended through voluntary codes allowing companies to have considerable discretion in their implementation. The ownership structure of Sri Lankan companies is characterized by a prevalence of family ownership and concentrated ownership, resembling the characteristics of the relationship-based model of corporate governance. Therefore, the application of corporate governance practices originating in Anglo-Saxon countries which typically experience dispersed ownership creates many compatibility issues affecting overall efficiency of corporate governance systems in Sri Lanka. However, no prior study has examined such issues empirically. This study contributes to fill this gap in the academic literature through an in-depth examination of the corporate governance practices of Sri Lanka.

This study examines the nature and the level of compliance with corporate governance best practices by Sri Lankan public listed companies, with a view to identifying critical issues of corporate governance practices, and the relationship between level of compliance and firm performance in Sri Lanka. It also examines stakeholders' perceptions of corporate governance practices in Sri Lanka and the impacts of ownership concentration on firm performance. Three separate data analyses are carried out to achieve these aims.

First, the compliance with corporate governance practices is examined through an analysis of a questionnaire survey covering 60 listed companies in Sri Lanka using a corporate governance index. The results show that levels of compliance by Sri Lankan companies to corporate governance best practices vary significantly among companies, and find that such variations directly relate to ownership structures of companies. The results provide prima facie evidence that family ownership and concentrated ownership have a negative influence on corporate governance practices while foreign ownership has a positive influence. The results further reveal that higher levels of compliance have a positive impact on financial performance, but have no impact on market performance.

Second, the stakeholder perceptions on eight aspects of the corporate governance system in Sri Lanka are examined using a questionnaire survey of 277 stakeholders from seven stakeholder groups. The analysis of results shows the majority of stakeholders are in agreement that sound corporate governance practices improve corporate financial, market and social performance, and the present status of corporate governance in Sri Lanka is not up to the required standard. Problems of corporate governance identified by stakeholders include: a lack of education in and awareness of corporate governance; inadequate regulations and enforcement; a lack of integrity and independence of directors; insufficient ethical standards; a lack of transparency; ownership concentration; and, political interventions, insider trading and corruption. Overall, the companies and regulators have failed to satisfy stakeholders' expectations of corporate governance standards in Sri Lanka.

Third, on the premise of an agency theory framework, and using both accounting and market-based performance indicators, the relationship between ownership concentration and firm performance is examined. A regression analysis is carried out based on pooled data of 846 firm-years collected from 157 listed companies over the period of 2001 to 2009. The results provide evidence of a strong positive relationship between ownership concentration and accounting performance measures, suggesting a greater concentration of ownership leads to better performance. However, results found no relationship between ownership concentration and market-based performance, suggesting the prevalence of numerous market inefficiencies and anomalies in the Sri Lankan stock market.

Overall, the results suggest that compliance with corporate governance practices by respondent firms is closely associated with ownership structure and that better governance seems to correlate with higher financial performance of the firms. The companies with foreign ownership embrace the market-based governance framework thoroughly whereas the companies with family ownership or concentrated ownership raises the question how appropriate is the market-based model of corporate governance for Sri Lankan companies. A policy implication of the results is that the corporate governance reform efforts should pay more attention to enhance the effectiveness of boards. More broadly, priorities should be given to making internal corporate governance mechanisms work better and enhancing the roles of regulatory agencies.

Acknowledgements

Many people made this study possible and I owe them all a debt of gratitude. I would however like to acknowledge the enormous support I have been given to make this study more meaningful and enriching.

I wish to extend my deepest gratitude to my supervisors, Dr. Anura De Zoysa and Dr. Kathy Rudkin for their scholarly support, academic guidance, and critical insight at all times during this task. Their advice and detailed comments on this thesis undoubtedly improved its standard substantially. I am particularly appreciative of Dr. Zoysa's analytical guidance and Dr. Rudkin's ability to teach scholarly writing with patience. I would like to express my heartfelt gratitude to them who are not only mentors but dear friends. I could not have asked for better role models, each inspirational, supportive, and patient and hope that I can in turn pass on these research values that they have given to me.

I extend my special word of appreciation to Prof. Mary Kaidonis, former Head, School of Accounting and Finance, University of Wollongong, for giving me an opportunity to gain teaching experience and supporting my financial needs at the same time by offering me contract employment in the school. I must acknowledge the encouragement and invaluable support of the academic and non-academic staff of the school in numerous ways. I am also grateful to Dr. Hema Wijewardena for his encouragement and assistance.

I am indebted to IRQUE Project, Department of Accounting of University of Sri Jayewardenepura for providing partial financial assistance for my doctoral studies. I gratefully acknowledge the collaboration of numerous individuals in Sri Lanka without whose support this study could not have been completed. Academic staff of Department of Accounting of University of Sri Jayewardenepura including former head of department Dr.Senaka Gamage and Professors M.W.Wickramarachchi, Samanthi Senaratne and Mangala Fonseka; Mr. Udaya Kariyawasam (former president) and Dr. D.B.P.H. Dissa Bandara of Securities and Exchange Commission of Sri Lanka; Mr.Udeni Alawattage, Mr. J.P.R.Karunaratne and Mrs. E.Fernando of Central Bank; Mr. Asite Talwatte and Devaka Cooray of Ernst and Young; Mr. Yohan Perera of

KPMG; Mr. Sanjaya Bandara of B.R.de Silva & Co; Mr. Sujeewa Mudalige and Mr. Nishan Fernando past presidents of Institute of Chartered Accountants of Sri Lanka; Mr. A.Chandrapala of Auditor Generals Department, Prof.P.S.M.Gunaratne of the University of Colombo; Mr. Gamini Wijesinghe and Mr. P.Gamage of Department of Inland Revenue; Mr. P. Atapattu and Miss. K. Damitha of the Treasury for the immense assistance in collection of annual reports, conducting the questionnaire surveys and providing necessary information. I extend my gratitude to Mr. Jayantha Priyarathne and his family for making my stay comfortable during the period of my data collection.

Last but not least I would like to thank my wife Deepani and son Ovindu who have walked along this journey right beside me and continually inspired me to move forward.

Chapter 1 : Introduction

1.1 Introduction

International interest in exploring effective corporate governance systems and practices has increased since the collapse of a large number of well-known companies. In response, many governments made incremental changes to their financial markets' corporate governance requirements (OECD, 2009, Kirkpatrick, 2009). Although there are a large number of studies on different aspects of corporate governance in developed markets, (Jensen and Meckling, 1976, Jensen, 1993, Mourdoukoutas and Papadimitriou, 1998, Gompers et al., 2003, Jackson and Moerke, 2005, Flora, 2006, Lawrence and Marcus, 2006), studies of corporate governance in emerging markets are sparse. The investigation of corporate governance practices in emerging markets is necessary because of vast differences in their social, cultural, and economic factors compared to developed markets.

The contextual settings of emerging markets differ vastly from those of developed markets. It is argued that the empirical findings of studies regarding developed markets have limited applicability in emerging markets (Dennis, 2006, Roy, 2007, Art and Kim, 2007). For example, the governance survey in Asia by Classens and Fan (2002) reveals that most Asian markets have governance systems with weak institutions and poor property rights, supporting the argument that conventional corporate governance systems have limited effectiveness in these economies. Poor corporate governance is widely viewed as one of the structural weaknesses in Asian economies, and it is considered as the main cause of the 1997 Asian economic crisis (Nam and Nam, 2004). The salient characteristics of most companies in Asian countries are the presence of controlling owners and family ownership with family members holding senior managerial positions (Nam and Nam, 2004). Therefore, additional research is needed on corporate governance problems associated with a concentrated ownership as such an agency problem means that controlling owners are able to pursue their private interests easily at the expense of non-controlling shareholders. Many reforms are based on the Anglo-Saxon model[1] of corporate governance, owing to

[1]The Anglo-Saxon model for corporate governance is a market oriented style of corporate governance which is largely characterized by dispersed share ownership, and strong and liquid capital markets due to good investor protection.

various countries' historical and/or economic contexts. Sri Lanka, being both a former British colony and an emerging market, is not an exception. Given this background, this study examines the nature of corporate governance practices and ownership concentration of Sri Lankan companies, their impacts on company performance, and the arising implications for Sri Lankan corporate governance regulation.

This chapter provides the overview of this study, specifically: the background; the objectives; the significance; scope of the study; research design and methods, and, limitations of the study. The organization of the thesis is provided in the final section of chapter.

1.2 Background of the Study

Sri Lanka, after nearly 150 years of British colonization, gained its independence in 1948. As a result, a plantation-based mercantile economy emerged and British business practices and regulations were introduced into Sri Lanka. Accordingly, components of its corporate governance system such as its: commercial and company law; accounting practices and regulations; education system; and, business practices were inherited from the British. The introduction to Sri Lanka of English company law and the commencement of share trading activities are major contributory factors to its development of corporate governance in the colonial era (Cabraal, 2003).

The business environment of Sri Lanka showed significant changes after 1977 as a result of the introduction of open economic policies. The development of capital markets accelerated when Sri Lankan economy shifted to market-orientated policies in 1977. Many economic changes took place with the introduction of open economic policies. Large scale development projects were funded by the international funding agencies. A Free Trade Zone program opened the door for foreign direct investments and multinational corporations. Imports and foreign exchange restrictions were relaxed for commercial businesses to grow. New forms of export-led industries such as garments were encouraged (Kelegama, 2004). As a result, many new developments have been introduced to the institutional (e.g., establishment of the Securities and Exchange Commission in 1987) and regulatory (e.g., *Companies Act No.17 of 1982*) framework of the country to regulate the corporate governance functions of the companies.

Although Sri Lankan company law was periodically amended in response to changes in British company law, it did not keep pace with British law. For example, until the Companies *Act of 2007* was enacted, the Sri Lankan companies were governed by the *Companies Act of 1982* which was enacted based on the *English Companies Act of 1948* (Wickramasinghe, 2006).

In this context, regulators and stakeholders recognized the need for further initiatives to ensure effective corporate governance practices by listed companies (Cabraal, 2003). The codification of Sri Lanka's corporate governance practices was commenced by the Institute of Chartered Accountants of Sri Lanka (ICASL). Their first code, relating to financial aspects of corporate governance, was developed in 1997. This was followed by additional codes developed by professional accounting institutions. In 2008, a code of best practices was developed by ICASL jointly with the Sri Lankan Securities and Exchange Commission (SEC). However, none of these codes is mandatory and therefore considerable freedom is enjoyed by the companies in implementing practices. Such discretionary behaviour leads to variations between companies. Further, these codes are adopted or adapted from codes developed in the UK and other developed countries. Consequently, Sri Lanka uses corporate governance practices originating in developed countries, despite noted differences in business and governance environments. This study examines the nature and levels of compliance with codified corporate governance practices by Sri Lankan companies.

Ownership structures of Sri Lankan companies make it difficult to implement best corporate governance practice. Samarakoon (1999) examined ownership structures of companies listed on the Colombo Stock Exchange (CSE), finding that their ownership is highly concentrated, and that there is a controlling shareholder of most companies. Ownership structures of Sri Lankan companies are characterized by: a wide prevalence of family ownership as ultimate owners; extensive use of pyramid ownership structures; cross-holdings; controlling shareholders' participation in management; and, the absence of a large community of arms-length institutional shareholders (Senaratne and Gunaratne, 2007). Such domination by controlling shareholders is similar to the

insider model of corporate governance[2], but Sri Lankan governance practices are drawn from UK governance practices. Hence the presence of controlling shareholders, widespread family ownership and the participation of controlling shareholders in management raise the question whether or not regulation based on the Anglo-Saxon model is appropriate for Sri Lankan companies, given this model is developed presuming that ownership of publicly traded companies is widely held, and their management are professional managers.

In the light of the above background, this study examines the compliance and performance implications of corporate governance practices, and the impacts of ownership structures on both levels of corporate governance regulatory compliance, and performance of Sri Lankan listed companies. Further it examines these issues from stakeholders' points of view.

1.3 Research Problem and Questions

The effectiveness of internal corporate governance mechanisms of public companies, for example boards' and managements' composition and operation, is subject to debate. This issue is particularly relevant for emerging markets which seek to implement suitable corporate governance systems for their economies.

As highlighted in the background of the study, Sri Lankan corporate governance practices are predominantly derived from the British practices. However, Sri Lankan corporate governance characteristics such as ownership concentration and bank led financing resemble the characteristics of relationship based model (Senaratne and Gunaratne, 2008). Further, corporate governance practices are largely recommended through voluntary codes. As a result, managers of public listed companies in Sri Lanka have considerable discretion in deciding the types and the extent of corporate governance practices implemented in their companies. Therefore, the issue addressed in this study is the effectiveness of corporate governance practices of Sri Lankan listed companies, by way of examining: the nature and level of compliance with best practices; and, the implications of ownership concentration on levels of compliance and firms' financial performance. This study recognizes that compliance itself does not

[2]The insider system of corporate governance is a relationship-based style of corporate governance which is characterized by highly concentrated shareholdings, concentrated voting power, cross corporate shareholding and inter-firm relationships.

reflect effectiveness, unless stakeholders are also satisfied with the prevailing system. Therefore, stakeholders' perceptions of the present corporate governance system in Sri Lanka are also examined. Accordingly, the following six specific questions are investigated.

(1) What is the historical development and current status of the corporate governance in Sri Lanka?
(2) What is the nature and level of compliance maintained by Sri Lankan companies in respect of the corporate governance best practices?
(3) Does the concentration of ownership with family, foreign or controlling owners and ownership structure have an impact on levels of compliance with corporate governance practices in Sri Lankan companies?
(4) Does facilitation of corporate governance best practices enable improvement in corporate performance in Sri Lankan companies?
(5) Do the current corporate governance practices in Sri Lanka meet stakeholders' expectations?
(6) Does ownership concentration influence firm performance of Sri Lankan companies?

1.4 Objectives of the Study

This study also provides an analysis of the nature and level of corporate governance practices applied by listed companies in Sri Lanka. The objectives of the study are eight-fold, as indicated below.

(1) assesses the corporate governance environment and the process of corporate governance codes' development in Sri Lanka;

Under this objective, the historical evolution of corporate governance practices, and the legislative and institutional frameworks governing corporate governance requirements of Sri Lankan public listed companies are examined. Furthermore, these are evaluated to understand the governance practices applicable to Sri Lankan listed companies.

(2) examine the nature of compliance with corporate governance best practices recommended by prevailing codes;

The nature of compliance with corporate governance best practices is assessed in this study based on a questionnaire survey carried out among board members of public

listed companies in Sri Lanka. The study specifically examines levels of compliance with corporate governance requirements, under eight dimensions of governance practices recommended by national and international governance codes.

(3) *assesses menthe levels of compliance with corporate governance best practices through the development of a Sri Lankan corporate governance index;*

Levels of compliance with corporate governance best practices are assessed based on scores derived from the development and application of a specific Sri Lankan corporate governance index (CGI), constructed using questionnaire survey data. The CGI is developed with eight sub-indices representing corporate governance dimensions examined in the study.

(4) *examines the impact of ownership on levels of compliance with corporate governance best practices;*

This study examines the impact of three ownership dimensions: namely; family, foreign, and controlling ownership on levels of compliance. A comparative analysis is carried out using sub-indices scores and scores for individual practices. Furthermore, the impact is assessed using statistical analysis.

(5) *examines the impacts of compliance with corporate governance best practices on firm performance proposing that a higher level of compliance enhances firm performances;*

Corporate governance is considered a decisive factor in promoting efficient markets and enhancing better corporate performance. Although some corporate governance practices are made mandatory through listing rules, a considerable amount of freedom is enjoyed by corporate managers in adopting best governance practices in their firms, since most of the practices are recommended by way of voluntary codes. Therefore, levels of compliance can be varied considerably amongst Sri Lankan companies. This study explores the proposition that a higher level of compliance enhances firms' performance. Hence, this study examines the impact of levels of compliance, as measured by scores of the developed CGI and its sub-indices, on the firm performance as measured in both financial terms and market terms.

(6) *assesses stakeholders' perceptions of corporate governance practices, strategies and identified issues;*

This study uses a questionnaire comprising a 5-point Likert scale, to collect primary data from seven stakeholder groups, about their perceptions of aspects of corporate governance in Sri Lanka. As it is important to examine the current status of Sri Lanka's corporate governance system from stakeholders' points of view, the study considers several aspects including overall status, identified issues, strategies, practices, and major promoters of corporate governance in Sri Lanka.

(7) *examines the impacts of ownership concentration on firms' performances; and,*

This examination addresses the impacts of ownership concentration on firms' performances, on the premise that high ownership concentration will enhance firms' performances by decreasing their monitoring costs. Ownership concentration is measured in terms of the first three largest shareholders' ownership, and the Herfindahl Index. Firm performance is measured both in financial terms and market terms. Several control variables are also employed in the analysis to control the size, age and leverage of the sample companies.

(8) *recognises features of current corporate governance practices, and make recommendations.*

The findings of empirical investigations are used to determine issues and salient features of corporate governance practices of Sri Lankan companies, in order to make recommendations to improve the corporate governance environment of Sri Lankan companies.

1.5 Significance of the Study

With the introduction of open economic policies in Sri Lanka in 1977, and the continuity of these policies by successive governments, the private sector has become the dominant force in the Sri Lankan economy. As a result there has been a significant growth in the corporate sector, particularly of the public listed companies. Economic policy changes have provided avenues for opening investment opportunities in the capital market for both local and foreign investors, resulting in significant improvements in contributions made by the corporate sector particularly the public listed companies to economic growth. Hence, corporate governance is now a vital issue

for the Sri Lankan economy as it facilitates increasing investors' confidence and thereby securing access to capital through the stock market. In addition, the failures of a large number of well-known companies and the regional economic crisis (e.g. East Asian Crisis 1997) have intensified an understanding of the need for corporate governance in economic development. In this context, it is important to review existing regulatory and institutional frameworks of corporate governance in Sri Lanka and to assess the governance practices of Sri Lankan companies.

As outlined in the background of the study, the social, cultural and economic conditions of Sri Lanka are significantly different to those of western countries. Owing to these differences, studies that have examined the efficiency of corporate governance practices in developed countries, especially western countries, may have limited applicability to evaluate corporate governance practices of Sri Lankan companies. More importantly, some governance practices may need to be adapted or new practices needed to suit local conditions. Furthermore, non-compliance with some of these practices may be due to non-compatibility to company-specific conditions such as ownership concentration, family ownership and representation of owners on boards. However, only limited information is available due to a dearth of prior studies examining these issues in Sri Lanka. Hence, it is imperative to conduct an in-depth study to assess the current status of corporate governance practices in order to identify deficiencies and to find out remedial actions to improve the existing corporate governance practices.

The other consideration of this study is the impact of ownership structure on Sri Lankan firms' compliance levels and financial performance. Corporate governance policies and practices are not developed in a vacuum; but rather, reflect underlying company-specific characteristics in addition to socio-economic conditions. Therefore, it is important to identify the company specific factors. Such an analysis provides a comprehensive view of governance practices of Sri Lankan companies and their impacts on performance. Hence, this study contributes to the existing body of knowledge in these areas in the Sri Lankan context.

1.6 Scope of the Study

The study is based on the Sri Lankan public listed companies of the Colombo Stock Exchange (CSE) and their stakeholders. The objectives of the study are achieved through three empirical investigations: first a survey of compliance with corporate governance best practices; second a survey of stakeholders' perceptions of corporate governance practices in Sri Lanka; and, third an examination of the impact of ownership concentration on firm performance in listed companies. Furthermore, an analysis of legal and institutional frameworks of corporate governance practices in Sri Lanka and their evolution is also undertaken to assess the present status of corporate governance requirements.

The first empirical investigation is based on a questionnaire survey carried out among the CEOs and the Chairmen of listed companies. All listed companies of CSE are included in the initial sample, and the final analysis is based on questionnaire responses of 60 companies. This investigation examines both the nature and the level of compliance with corporate governance best practices by Sri Lankan public companies. The nature of compliance with best corporate governance practices is evaluated based on questionnaire survey data using percentage and frequency analysis. The level of compliance with corporate governance practices is assessed based on the corporate governance index developed on questionnaire survey data. Furthermore, the impacts of ownership concentration on compliance with corporate governance practices are also examined based on the corporate governance index scores.

The second investigation examines the perception of various stakeholder groups in relation to present status, strategies, practices and main issues of corporate governance and as to how these issues should be addressed in Sri Lankan context based on the questionnaire survey. The final analysis is based on 277 responses from seven stakeholder groups consisting of Non-executive Directors; Independent Audit Professionals; Accountants; Government Policy Makers; Government Audit and Tax Officers; Academics; and Investors.

The third investigation examines the performance implications of ownership concentration based on a sample of 157 listed companies over the period of 2001 to 2009. The final sample consists of 846 firm-years. The bank, finance and insurance

sector is excluded from this sample due to its non-comparable nature of applicable regulations on ownership concentration and performance measures.

1.7 Concepts, Research Design and Methods

Corporate governance is defined as "the structure of relationships and corresponding responsibilities among a core group consisting of shareholders, board members and managers designed to best foster the competitive performance required to achieve the corporation's primary objective" (OECD, 1999, p.198). It is one of the key elements in improving economic efficiency and investors' confidence in the market. The corporate governance structure of a firm is expected to motivate managers towards improving their business through supervision of their performance and ensuring their accountability to shareholders. Thus, the OECD (2004) advocates that companies should continuously pursue good corporate governance practices in order to use resources more efficiently and thereby achieve high growth. International guidelines on corporate governance prescribe the application of governance principles and practices as a whole. It is important to study the governance system of a firm as a whole instead of focusing only on a particular aspect of corporate governance. Thus, this study examines corporate governance categorizing eight dimensions: 1) board structure and independence; 2) board procedure and effectiveness; 3) directors' remuneration; 4) audit committee procedure; 5) disclosure and transparency; 6) disclosure reliability; 7) shareholders' rights; and, 8) related party transactions. The corporate governance practices are recognized based on Sri Lankan codes, OECD (2004) principles, and the findings of previous studies. These practices are further scrutinized through the perusal of international codes especially codes developed in U.K. Thus, principles and practices recommended by the Sri Lankan governance code (ICASL and SEC, 2008), the codes developed in U.K. and OECD (2004) principles form the basis for recognition of 'corporate governance best practices' of the study.

The use of a particular method for a research project depends on the scope, purpose and target population of the study, as well as the resources available to the researcher (Gill and Johnson, 2002). The descriptive research method is primarily employed considering the nature of the empirical investigations of the study. The causal research method is also employed in examining causal relationships between ownership concentration and firm performance. Descriptive research provides information

regarding the current status and the characteristics of a particular phenomenon. This is usually exploratory in nature and determines the status of a particular area (Heppner et al., 2008). Thus, this study primarily applies descriptive research methods to explore the present status of corporate governance in Sri Lanka, and surveys corporate governance compliance and stakeholders' perception in the study. The main advantage of descriptive research is its usefulness in describing the occurrence and characteristics of the phenomena that is being studied, and therefore it is useful to develop remedial actions as input into managerial decision-making. However, as causal relationships cannot be analysed using descriptive methods, the causal research method employed in examining the impact of ownership concentration on Sri Lankan firms' performance. Accordingly, the approach described below has been followed in achieving the objectives of the study.

In objective one, first the historical evolution of corporate governance practices in Sri Lanka is examined to identify the influential sources of corporate governance in Sri Lanka. Existing legislative and institutional frameworks are evaluated. Thereafter, the corporate governance requirements for listed companies are examined based on company law, codes of best practices, and other regulatory requirements. As this is an exploratory study, the analysis is primarily descriptive.

The questionnaire survey method is used in realizing objectives two to five. The development of the questionnaire has undergone two stages. In the first stage attributes of the Sri Lankan corporate governance system and associated practices have been identified by reference to national and international codes, regulations and guidelines. These attributes are classified into eight dimensions representing various aspects of corporate governance. In the second stage specific questions are developed by reference to these attributes and prior research studies. A questionnaire survey was conducted to collect data from the CEOs and Chairmen of listed companies regarding compliance with identified best corporate governance practices. After conducting different validity test on the responses, the data were analysed using mean values, percentages and frequency distribution to understand the nature of compliance to corporate governance practices.

Another aspect considered in the study is the assessment of levels of compliance with corporate governance best practices amongst sample companies. The relative levels of compliance are assessed based on a Corporate Governance Index (CGI) which was constructed using survey data. The CGI consists of eight sub-indices representing major corporate governance aspects examined in the study. The CGI scores of sample companies indicate the extent to which they have complied with the best practice. The scores of the CGI and the sub-indices are analysed using descriptive statistics and frequency analysis to find out overall behaviours of compliance levels of corporate governance practices. As the compliance to governance practices can significantly be different across the nature of ownership of the firm, the analysis is carried out across three ownership dimensions namely; family, foreign and controlling ownership. Both family and foreign owners become part of controlling ownership if they function as the controlling owners. A comparative analysis is also carried out for subgroups identified on these ownership dimensions.

The impact of ownership on the level of compliance is assessed in the next stage. As the level of compliance can differ across the firms due to their ownership composition, a comparison is carried out between two sub-groups identified for each ownership dimension. The comparison is carried out using the scores of the overall index and sub-indices. In order to discover the impact of ownership on the level of compliance, the mean differences of the overall index scores and the sub-indices scores of subgroups are compared using the independent samples t-test. Accordingly, subgroups of family ownership, foreign ownership and controlling ownership are compared separately.

The impact of levels of compliance with corporate governance practices on the performance of the firms is analysed on the proposition that a higher level of compliance enhances firm performance. The CGI scores of sample companies are used as the indicator of levels of corporate governance compliance. In order to examine the performance implications of levels of compliance, the sample is divided into two sub-samples, high compliance and low compliance companies, based on index scores. As performance indicators, both financial and market performance measures are alternately employed in the analysis. The impact of levels of compliance on performance is assessed based on correlation analysis and the t-test for independent samples.

In objective six, the perceptions of various stakeholder groups in relation to the present status of Sri Lankan corporate governance is assessed using the questionnaire survey method. The questionnaire was conducted among seven identified stakeholder groups: 1) non-executive directors; 2) independent audit professionals; 3) accountants; 4) government policy makers; 5) government audit and tax officers; 6) academics; and, 7) domestic individual investors. The questionnaire includes seven questions with 70 items on a 5-point Likert scale. It collects primary information from these stakeholder groups about their perceptions on seven aspects of corporate governance, namely: 1) important components of corporate governance; 2) performance implications of corporate governance; 3) present status of corporate governance; 4) major issues of corporate governance; 5) corporate governance strategies; 6) corporate governance practices; and, 7) key players and promoters of corporate governance in Sri Lanka. These elements are identified by the researcher as relevant to the study and there are no existing standard definitions of these aspects of corporate governance. The survey data is analysed using percentages and mean values. The average score of each item is calculated for the overall sample and for the sub-samples of seven groups separately, to assess the pattern of respondents' perceptions on the given issues. The Kruskal-Wallis test is carried out to find out whether there are significant differences among the seven stakeholder groups.

In objective seven, the impact of ownership concentration on firms' performance is examined based on secondary data obtained through the OSIRIS database, the CSE database, and the annual reports of the sample companies. The ownership variables consist of both ownership structure and ownership concentration variables. Both accounting and market performance measures are alternately employed as the dependent variable in the analysis model, as it explores diverse performance implications of ownership variables. The performance of a company depends on various factors such as operational efficiency, size of the firm and financial risk. To control the effects of these factors, size, age and leverage of sample firms are included as control variables in the data analysis model. The analysis is carried out on the premise of agency theory, which argues ownership concentration and individual shareholders' share ownership make positive impacts on firm performance. Based on the assumed causal relationship, a regression analysis is carried out to measure the impact of ownership concentration on firm performance, using the statistical package SPSS.

1.8 Limitations of the Study

Since the questionnaire survey is used as one method of data collection, the limitations commonly applicable to questionnaire surveys are equally applicable to this study. Second, the scope of this study of corporate governance survey is limited to public listed companies. Due to practical reasons, no attempt was made to include both government sector organizations and non-listed companies. Thus, the level of compliance to corporate governance practices by government owned enterprises and non-listed companies cannot be discerned by analysing the results of this study. Furthermore, the analysis of the corporate governance survey is limited to 60 listed companies due to data collection limitations. The small sample size prohibits an in-depth statistical analysis of the relationships between the variables. Therefore, additional statistical analyses such as regression could not be employed in analysing survey data. Third, the CGI of the study is based on the codes of best practice that have been developed in line with the Anglo-Saxon model. This is because both the Sri Lankan Companies Act and the codes of best practice are primarily based on the British model. However, the practices developed in the Anglo-Saxon model may not fully address the requirements of Sri Lankan companies. Therefore, benchmarking governance practices of local companies with this model may not fully reflect the exact state of their governance. Finally, the analysis of performance implications of ownership concentration is limited to direct shareholdings of owners without analysing ultimate ownership, due to the practical difficulty in obtaining indirect ownership information of Sri Lankan companies.

1.9 Organization of the Thesis

The study is organized into eight chapters including this introductory chapter, which provides an overview of the study. It deals with the research issue, the objectives, significance, and the research design and method of the study. It also briefly explains the scope and limitations of the study.

Chapter two presents the literature review of the study. This chapter reviews: the literature on theoretical perspectives and different models of corporate governance; standardization and measurement of corporate governance practices; determinants of the level of corporate governance; and, the performance implications of corporate governance.

Chapter three examines the evolution of corporate governance practices with special reference to the legislative and institutional frameworks of corporate governance of Sri Lankan public listed companies. It also examines the development of corporate governance codes, main players and their roles in developing governance codes. Hence, this chapter describes the codes of best practice of corporate governance and regulatory requirements of corporate governance applicable to public listed companies.

Chapter four discusses the research design and methods used to examine the corporate governance practices and their association with corporate performance. The research methods have been developed based on the existing literature and describe in detail the sample, sample selection criteria, data, data collection and definition of variables of the study, and the models and tests used in the study for data analysis.

Chapter five explores the nature and level of compliance of corporate governance practices. The first section of this chapter provides a detailed descriptive account of corporate governance practices of Sri Lankan listed companies followed by the analysis of the level of compliance using the scores of CGI and sub-indices for each dimension of corporate governance practices. The next section provides analysis of ownership dimensions and their impact on levels of compliance. The final section deals with the analysis of performance implications of corporate governance compliance.

Chapter six presents the analysis of the stakeholders' expectations of corporate governance practices of Sri Lanka. The first section provides the analysis of overall responses to the survey, the non-responses bias and the important characteristics of respondents. This is followed by an analysis of stakeholders' opinions on current practices and issues of corporate governance in Sri Lanka. The next section discusses the further issues raised by stakeholders and their recommendations.

Chapter seven examines the impact of ownership concentration on the performance of Sri Lankan listed companies. The first section provides a brief discussion of the background of the study and the regulatory requirements regarding shareholdings of Sri Lankan listed companies. The profile of the sample companies and the nature of ownership concentration are examined in the next section. The final section deals with the analysis and empirical findings of the study.

Chapter eight provides a summary of findings of analyses carried out in chapters three, five, six and seven, the conclusion and recommendations based on the empirical analysis along with the directions for future research.

Chapter 2 : Theoretical Perspectives and Socio-Economic Setting of Corporate Governance: Literature Review

2.1 Introduction

Corporate governance concerns the exercise of power to direct and control companies (Clarke, 2004). The OECD: defines corporate governance as “the structure of relationships and corresponding responsibilities among a core group consisting of shareholders, board members and managers designed to best foster the competitive performance required to achieve the corporation’s primary objective” (OECD, 1999a, p.198). Corporate governance structures specify the distribution of rights and responsibilities among different participants such as; board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on the affairs of a corporate entity. Furthermore, corporate governance provides the structure for the setting and achieving of corporate objectives. However, corporate governance has wider implications for the economic development and social well-being of a country, by way of providing incentives to achieve business performance, and accountability and transparency to ensure an equitable distribution of wealth (Clarke, 2004)

The recent global financial crisis has encouraged moves towards better corporate governance, and therefore has driven many governments around the world to make incremental changes to the corporate governance requirements in their financial markets (OECD, 2009, Kirkpatrick, 2009). Corporate governance has significant implications for the financial stability and performance of companies and thereby the economic growth of a country (Rezaee, 2009). Thus, the relative efficiency of different corporate governance systems, the efficiency of corporate governance mechanisms, and compliance with corporate governance practices have become important practical issues in the corporate governance debate (John and Senbet, 1998). These issues receive greater attention in emerging markets, when they seek to implement suitable corporate governance systems for their economies.

Corporate governance in developed markets has evolved gradually over several centuries as a result of the economic development of industrial capitalism (Chowdary,

2003). Thus, corporate governance systems are considered to be formed nationally by their economic, political and legal backgrounds. As a result, corporate governance of a country becomes a complex system including legal and institutional frameworks; legal provisions; corporate governance guidelines and codes; code of ethics; professional institutions; and, social, political and economic environment. However, in emerging markets most of these components have missing links due to historical and economic reasons. For example, poor corporate governance is considered as one of the main causes of the Asian economic crisis (Nam and Nam, 2004). Therefore, the development of a good corporate governance system for these markets becomes a complex issue (Chowdary, 2003). Sri Lanka, being an emerging market, is not an exception. As the establishment of strong corporate governance system is imperative for any county to ensure the economic health of companies, corporate governance should be evaluated in broader conceptual and contextual settings.

This chapter presents the literature related to various concepts of corporate governance with special reference to corporate governance systems, and their implications for firm level corporate governance practices and performance. In order to understand the literature on a broader conceptual setting, this chapter examines the various definitions, theoretical perspectives and different systems of corporate governance in the next three sections. In section five, the corporate governance debate on convergence and contextualization is examined. Sections six and seven present the literature relating to standardization of corporate governance practices and measurement of the levels of compliance with recommended practices. The review of literature regarding performance implications of corporate governance and ownership structures are presented in sections eight, nine and ten. The evidence on Sri Lankan corporate governance is presented in section eleven, as the study examines levels of compliance with corporate governance practices and their performance implications in the Sri Lankan context. A summary is then provided in the final section.

2.2 Corporate Governance Approaches and Definitions

Corporate governance is popularly understood as the system by which companies are directed and controlled (Cadbury, 1992). The corporate governance system of a country is a part of wider institutional structure that regulates the relationship between executives who control the organization's resources and activities and those social and economic stakeholders who possess a legitimate vested interest in the firm's activities (Carney and Gedajlovic, 2001) Corporate governance can therefore be viewed as a socially constructed force that determines the activities and strategic behaviour of firms.

Although the terms 'governance' and 'management' are often used together they differ from each other. Corporate management is the general process of making decisions within a company. Corporate governance is the set of rules and practices that ensure that a corporation is serving all of its stakeholders. At the most fundamental level corporate governance is about economic health of companies.

The term 'corporate governance' is a relatively new one in academic debate although the issues it addresses have been in existence for much longer, even prior to Smith (1776). The pioneering work by Berle and Means (1932) addresses the main issues of a corporation which provides essential impetus for a corporate governance debate. Among those issues, the consequences of the separation of ownership from control, the concentration of economic power in a large corporation, and the emergence of a powerful class of professional managers who are insulated from the pressure of stockholders and the larger public have received much attention (Eisenhardt, 1989).

Berle and Means (1932) further state that the interests of managers diversify from those of owners of the firm, which is the prime concern in modern agency theory. Tricker (2000) expresses a similar view and states that governance issues arise when a corporate entity acquires the status of legal entity, in which ownership is separated from its management. Separation of ownership from management intensifies the need to search for good governance practices in order to secure owners' interests, which is the concern of the agency theory. However, corporate governance is extensively examined under different models such as the finance model, the stewardship model, the stakeholder model and the political model. These theoretical perspectives provide

different approaches to investigate modern corporations and their governance, resulting in various concepts and definitions of corporate governance.

Berghe and De Ridder, (1999) explore a range of contemporary definitions for corporate governance and claim that it is hard to define the term without ambiguity. They have identified three groups. The first group defines corporate governance in terms of governance policy and supervision. The second group focuses on the relationships of the parties involved and balancing their interests. The third group focuses on the mission of the enterprise and its outcomes. All these definitions explicitly or implicitly refer to the existence of conflicts of interest between insiders and outsiders, with an emphasis on conflicts arising from the separation of ownership and control.

Viewing the corporation as an association of explicit and implicit contracts, Lewin claims that "corporate governance is a socially contracted force field of driving and preventing forces that shape a firm's strategic behaviour" (quoted in Carney and Gedajlovic, 2001, p.337). Donaldson (1990, p.370) defines corporate governance as "the structure whereby managers at the organisational apex are controlled through the board of directors, its associated structures, executive incentive, and other schemes of monitoring and bonding." They also observe that monitoring and bonding is carried out through various contracts.

Shleifer and Vishny (1997, p.737) use an agency perspective in analysing governance issues, defining corporate governance as "the ways in which suppliers of finance to companies assure themselves of getting a return on their investment." Prowse (1998b, p.2) expresses a similar view by focusing on accountability towards outside investors and defines corporate governance as "the rules, standards and organizations in an economy that govern the behaviour of corporate owners, directors, and managers and define their duties and accountability to outside investors, i.e., shareholders and lenders". The proponents of agency theory overwhelmingly focus on the conflict of interest between management and external investors, ignoring other stakeholders and their roles in corporate governance.

The proponents of stakeholder theory provide broader definitions covering a wider range of groups involved in the corporate governance process. For example,

Demb & Neubauer (1992, p.9) state that "Corporate Governance is the process by which companies are made responsive to the rights and wishes of stakeholders". Turnbull (1997) describes corporate governance as "the influences affecting the institutional processes, including those for appointing the controllers and/or regulators, involved in organizing the production and sale of goods and services." A similar concept is suggested by Solomon and Solomon (2004, p.14) who define corporate governance as "the system of checks and balances, both internal and external to companies, which ensures that companies discharge their accountability to all their stakeholders and act in a socially responsible way in all areas of their business activity". Monks & Minow (1995) view corporate governance as the relationship among various participants in determining the direction and performance of corporations. John and Senbet (1998, p.372) propose that "corporate governance deals with mechanisms by which stakeholders of a corporation exercise control over corporate insiders and management such that their interests are protected".

Gomez (1997) effectively distinguishes between management and governance and describes the two-tiered governance model adopted by most of the European countries as follows.

> "management… the more or less rationalised mechanical organisation of the hierarchies and power to achieve efficiency, once the objectives have been defined…; governance… the choice of objectives and the means to achieve them in order to check that they have actually been achieved in the interest of the parties in the enterprise"(quoted in Berghe and De Ridder, 1999 p.21).

Gomez' definition of corporate governance in terms of supervisory level is more suitable to explain the two-tiered board adopted in European model. But it is less applicable to explain a single tiered or unitary board since in unitary board the division between 'policy' and 'governance' is not always clear.

The OECD provided a comprehensive definition incorporating not only the expected performance implications of a firm, but also the expected economic impacts of society at large, as follows:

> "the rules and practices that govern the relationship between the managers and shareholders of corporations, as well as stakeholders like employees and

creditors- contributes to growth and financial stability by underpinning market confidence, financial market integrity and economic efficiency" (OECD, 2004, p.1).

It is clear that corporate governance refers to the authority to direct, organise, and control the corporate entity. Therefore when considering corporate governance practices, one has to focus on the processes used to direct and manage the business affairs of an entity with the intention of balancing the following: the attainment of corporate objectives; the alignment of corporate behaviour with the expectations of society, and, the accountability to owners. The process of corporate governance involves: responsibilities (who should do what?); accountability (to whom should those with responsibilities account? and how?); and, checks and balances (the system of supervision and control procedures and communication flows). However, many issues can arise in carrying out these responsibilities.

Viewing the corporation from an agency point of view Hart (1995) argues that all corporate governance issues revolve around two main conditions. First, there has to be an agency conflict involving members of the organization: owners; managers; workers, and, consumers. Second, transactions costs are such that this agency problem cannot be dealt with through a contract. According to the Cadbury Code (1992), members of boards of directors are responsible for the governance of their companies. The responsibilities of boards include: the setting out of the strategic aims of the firm; providing the leadership to put them into effect; supervising the management of the business; and, reporting to stakeholders on their stewardship. The shareholder's role in governance is to appoint the directors and the auditors and satisfy themselves that an appropriate governance system is in place. However, conflict between these parties is one of the main reasons for most of the corporate governance issues faced by modern corporations, and causing the evolution of corporate governance systems around the world.

Different governance systems have evolved around the world to address the relationship between the firm and society, owing to numerous differences in institutional and cultural norms, resource endowments, political traditions and legal systems (Carney and Gedajlovic, 2001). However, effectiveness of these governance

systems is not agreed upon universally. Different theoretical perspectives are generally applied to evaluate these governance systems and their related concepts and issues. However, the various issues and concepts of corporate governance are subject to different interpretations under these different theoretical perspectives. For example, accountability, one of the important concepts of corporate governance, has undergone a paradigm shift from stewardship, to agency, to accountability to stakeholders (Sternberg, 1999).

Furthermore, most of these emergent theories are examined extensively in developed economies, assuming that contextual conditions of these economies provide universal reference. However, owing to the existence of vast differences between developed and emerging markets, these theories need to be tested in the different contextual settings, especially within an emerging market context in order to validate their claims. The theoretical perspectives of corporate governance, irrespective of their preconception towards western thought, provide an analytical framework to view the nature and efficiency of different governance systems across counties. The different theoretical perspectives of corporate governance, which are useful in evaluating the corporate governance system of a country, are discussed in the next section. This study contributes to the literature by examining the corporate governance environment of Sri Lanka, in order to assess the compliance to good corporate governance practice by Sri Lankan companies, and the implications for their performance.

2.3 Established Perspectives of Corporate Governance

Corporate governance becomes a multifaceted issue owing to the development of complex corporate organizations and globalization of business operations. Thus, an analysis of corporate governance requires strong theoretical foundations to capture the efficiency of existing corporate governance mechanisms in different contextual conditions. However, most theories of corporate governance offer a single analytical framework which could have limitations in explaining complex corporate governance issues. Thus this section provides an analysis of different theories in order to understand their relative strengths and relevance in analysing corporate governance issues.

The corporate governance survey by Hawley and Williams (1996) identified four theoretical models that were extensively applied in analysing various aspects of

corporate governance. These models include (1) The Finance Model; (2) The Stewardship Model; (3) The Stakeholder Model; and (4) The Political Model. In addition, other theoretical models such as the Resource-Dependence Model, the Institutional Model, the Participative Model, the Policy Governance Model, and the Strategic Leadership Model are also applied in analysing efficiencies of different corporate governance mechanisms in diverse theoretical studies (Ho, 2005). These theories have however, produced contradictory results regarding firm performance and corporate governance, in particular relating to different cultural contexts. Despite these contradictions and different theoretical perspectives, evidence clearly supports the link between various dimensions of corporate governance and firm performance (Demsetz and Villalonga, 2001, Hillman and Dalziel, 2003, Sanjai and Brian, 2007).

2.3.1 Agency theory

Agency theory emerged from the seminal papers of Alchian and Demsetz (1972) and Jensen and Meckling (1976) recognising the firm as a nexus of contracts among individual factors of production. Thus, agency theory rests upon the contractual view of the firm. The essence of the agency problem is the separation of the management from the suppliers of finance to the firm. Agency theory focuses on the relationship between principals such as shareholders, and agents such as company executives and managers. Jensen and Meckling (1976) define this relationship as a contract under which the principal engages the agent to perform some service, expecting the agent to act and make decisions in the best interests of the principals. However, due to opportunistic behaviour, the agent may not necessarily make decisions in the best interests of the principals (Padilla, 2002). Such a problem was first highlighted by Adam Smith in the 18th century in his famous book 'Wealth of Nations' as follows:

> "The directors of such (joint-stock) companies, however, being the managers rather of other peoples' money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private co-partnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation for having it. Negligence and profession, therefore, must always prevail, more or less, in the management of affairs of such a company." (quoted in Jensen and Meckling, 1976, p.305)

Agency theory argues that managers are focused on self-interest rather than on the interests of the owners. This suggests that ownership and managerial interest may not be aligned, leading to agency costs and internal inefficiencies. Jensen and Meckling (1976) claim that agency costs consist of three different components: monitoring costs, bonding costs and residual loss. Monitoring costs are the control costs incurred by the principal to mitigate the devious behaviour of the agent. Bonding costs are incurred to ensure that the manager makes decisions beneficial to the principal. Residual loss is a potential cost that occurs when both monitoring costs and bonding costs fail to control the divergent behaviour of the manager. Due to the existence of agency costs and internal inefficiencies, agency theory argues that the purpose of corporate governance mechanisms is to provide shareholders with some assurance that managers will try to achieve outcomes that are in the shareholders' interests (Jensen and Meckling, 1976). The internal and external governance mechanisms such as an effective board structure, compensation contracts, active monitoring of executives through concentrated ownership and market for corporate control, help to bring the interest of managers in line with those of shareholders. However, a basic conclusion of agency theory is that the value of a firm cannot be maximized as managers normally hold the executive power which allows them to expropriate value for their own interest (Turnbull, 1997). Irrespective of this claim, agency theory provides a broad analytical framework to examine how successful corporate governance systems can curb opportunistic managerial behaviour, securing a fair return on investment for the suppliers of finance.

2.3.2 Stewardship Theory

Stewardship theory assumes that managers are not opportunistic agents, but good stewards of corporations who diligently work towards owners' interests by securing high level of corporate profits and shareholders' returns (Donaldson and Davis, 1994). Hence, stewardship theory differs from agency theory with respect to the motive of managers. According to Gay (2002) stewardship theory is also derived from the economic model of human behaviour, classified by McGregor as Theory Y, which assumes that people are inherently motivated to work and perform a good job. Therefore, stewardship theory purports there is no conflict between managers and owners, and the optimum governance structure allows coordination of the companies to perform most effectively towards the betterment of the owners' interest.

Donaldson and Davis (1994) note that managers are principally motivated by their needs for achievement of responsibility. Therefore, they argue that organizations are better served by specialist executive managers who are free from rigid control by non-executive director dominated boards. They further argue that most research studies examining board composition make the assumption that independent boards are good and produce the expected findings. However, Donaldson and Davis (1994) point out that a non-executive board of directors is, by its design, an ineffective control device that might fail to present good firm performance. Thus, the proponents of stewardship theory expect superior corporate performance if the majority of board members represent inside directors, as they work to maximise profit for shareholders. Furthermore, they claim that inside directors understand the business better than outside directors, and therefore, inside directors are able to make superior decisions (Donaldson, 1990, Donaldson and Davis, 1994). The underlying argument for this assertion is that the managers are naturally trustworthy and there will be no major agency costs associated with managers.

As a result of this appreciative view of management, stewardship theory takes a more relaxed view in respect of CEO duality and favours boards having more specialist executive directors instead of having independent outside directors. However, Turnbull (1997) claims that the inclination of individuals to act as stewards or self-serving agents may be dependent upon the institutional and cultural context. In this case, both stewardship and agency theories can be seen as sub-set of political and other broader models of corporate governance. Thus the validity of theoretical arguments relating to managers' behaviour in achieving better corporate performance and the role of corporate governance mechanism in this respect has to be evaluated with due consideration to political framework within which these constituents are operated.

2.3.3 Stakeholder Theory

Stakeholder theory views the firm as a system of stakeholders operating within the larger system of the host society, which provides the legal and market infrastructure for the firm's activities (Clarkson, 1994). Freeman and Reed (1990) define the organisation as multilateral agreements between the enterprise and its stakeholders. According to these views, the firm should not be regarded as bundles of assets belonging to shareholders but rather, as institutional arrangements for governing the

relationship between all of the parties that contribute firm-specific assets. According to Freeman (1984) the original list of stakeholders includes shareholders, employees, customers, lenders, and suppliers. However, a wider definition of stakeholders tends to consider any group or individual who can affect or is affected by the achievement of the organisation's objective. Jones and Wicks (1999) recognises the following as the essential premises of stakeholder theory: (1) the corporation has relationships with many constituent groups (stakeholders) that are affected by its decisions; (2) the theory is concerned with the nature of these relationships in terms of both processes and outcomes for the firm and its stakeholders; (3) the interests of all (legitimate) stakeholders have intrinsic value, and no set of interests is assumed to dominate others; and (4) the theory focuses on managerial decision making. The stakeholder view of corporate governance focuses on the needs and concerns of all stakeholder groups and how their interests are taken into account and protected by corporate managers.

In the premise of stakeholder theory, corporate governance can be viewed as control mechanisms designed for the efficient operation of a corporation on behalf of its stakeholders. The control mechanisms themselves are necessitated by separation of ownership from control, which is common to any market economy. John and Senbet(1998) view corporate governance as a means by which various stakeholders apply control over a corporation by exercising certain rights, which are established in the existing legal and regulatory frameworks as well as corporate bylaws. Thus stakeholder theory could be reconciled with the agency theory by broadening the classical agency relationship between managers and owners to incorporate the relationships between managers and all stakeholders. The adoption of the stakeholder theory has led companies to re-examine their vision, mission and values, and also the different types of performance measures applicable to various stakeholders. The stakeholder approach is seen as a commercial necessity in a world where competitive advantage stems more and more from the intangible values embodied in human and social capital. Hence, it has become common for companies to set goals which take account of environmental quality and social equity in addition to the traditional measures of economic performance. Therefore, the future course of corporate governance is likely to be strongly influenced by societal pressures, where the companies have to focus their attention on the wider community of stakeholders.

2.3.4 Political Theory

Political theory aims to explain, justify or criticize the nature of power in society. It outlines the balance of power between states, groups and individuals. At the macro level, the political model of corporate governance recognizes the allocation of corporate power, privileges and profits between owners, managers and other stakeholders and how this is done by the government through its various constituencies. Hawley and Williams (1996) claim that governments have exercised strong political influence on firms and as a result, politics has influenced the governance structures of firms. For example, political theory brings the approach of developing voting support from shareholders, rather than purchasing voting power.

Corporate governance studies which examine the political behaviour of a corporation focus their discussion on the micro aspects of the political model (Pound, 1993, Hawley and Williams, 1996). The micro level political model focuses on how controlling power can be operated by dispersed shareholders through a political process. For example, Pound (1993) claims that the political model of governance is an approach in which active investors seek to change corporate policy by developing voting support from dispersed shareholders, rather than by simply purchasing voting power or control. Hence, this becomes a new form of governance, where politics, rather than finance, plays a dominant role. This approach is exceptionally less expensive than takeovers as a method of acquiring controlling power (Pound, 1993). Therefore, the political model of corporate governance places severe limits on the traditional economic analysis of the corporate governance problem. Political theory looks at governance through a different lens from other theories. It locates the issue of performance implications of corporate governance in a broader political context. Thus, it becomes necessary to understand the political marketplace to analyse the performance implications of corporate governance practices. The roles played by capital market mechanisms in governance become vulnerable to a political marketplace. For example, Gordon & Pound (1991) show that corporations with fewer anti-takeover provisions in their constitutions out-performed those with anti-takeover measures in place. Hence, proponents of the political theory of corporate governance claim that a proper understanding of political marketplace behaviour is imperative to carrying out critical examination of major governance issues, such as the role played by capital market mechanisms in corporate governance and the performance implications of governance practices.

2.3.5 Other Approaches for Analysing Corporate Governance

The theories discussed so far are largely focused on internal monitoring issues of corporate governance. However, there are other theoretical approaches such as the resource-dependence model, cultural perspectives, institutional models, and policy governance models that are focused, rather, on external governance mechanisms including external challenges and securing resources from the external environment. For example, resource-dependence models concentrate on the role of the board of directors in providing access to resources needed by the firm. It claims that successful organizations develop internal structures to satisfy environmental requirements. Pfeffer (1972) argues that a company's board size and its composition are a rational response to the conditions of the external environment. According to Hillman et al.(2000), directors bring resources to the firm, such as: information; skills; and, access to key constituents such as suppliers, buyers, public policy makers, and social groups. They also bring legitimacy. Thus, directors are viewed as linking networks which connect the business to its strategic environment. It has been argued that this network secures the continuous supply of required resources to enhance organizational functioning and performance. The identification of such networks, and the directors' role in building those networks, provide another insight into governance processes and powers. Thus, a resource-dependence model provides another analytical dimension in respect of performance implications of corporate governance systems and practices.

Cultural perspectives provide an alternative approach for the analysis of corporate governance. Hofstede (1980, p.25) defines culture as "the collective programming of the mind which distinguishes the member of one human group from another'. He recognizes four dimensions which distinguishes one culture from another. These dimensions include individualism versus collectivism, large versus small power distance, strong versus weak uncertainty avoidance, and masculinity versus femininity. It is revealed that differences within these dimensions diversely influence trust relationships of stakeholder groups of the corporate entity. For example, according to Hollingsworth et al. (1994, p.6) corporate transactions are conducted "on the basis of mutual trust and confidence, which is normally sustained by stable, preferential, mutually obligated and legally non-enforceable relationships". The parties involved in transactions may be kept together either by value consensus or resources dependency through culture or community. Turnbull (1997) states that this claim recognizes the fact

that the transactions are governed by the networks which exists at Meso-level i.e. the intermediate location between the micro level of the firm and the macro level of the whole economy. La Porta et al. (1997) examine the role of trust and social capital in motivating individuals to assist socially, in order to increase productive efficiency. They found that trust is greatly and positively correlated to firm efficiency and civil participation. They also found that the dominant religion in a culture can affect trust. For example, they observed that as the proportion of the population involved in hierarchical religions, like Catholicism, decreases, trust in large organizations increases. The hierarchical character appears to have a strong negative correlation with trust and seems to have a negative influence on the quality of institutions. Stulz and Williamson (2003) evaluate the influence of religion on financial development, by distinguishing between the rights of the shareholders and those of the creditors. They observe that only religion has a decisive influence on the rights of creditors. Its explanatory power appears superior to that of language, openness of international trade, individual income level and the legal origin. Licht (2001) proposes the use of concepts of intercultural psychology in order to evaluate the effects of cultural differences on the national system of governance, having considered the national culture as one of the principal determinants of efficiency. These conceptual arguments and empirical evidence show that the culture has indirect authority on corporate governance and corporate performance, and so national culture influences corporate efficiency. Therefore, cultural perspectives of corporate governance provide a different standpoint to evaluate the efficiency of various governance mechanisms and practices.

2.3.6 Current Status of Theorizing Corporate Governance

Corporate governance does not have any widely accepted theoretical base. Although the existing theories make various attempts to explain how the modern corporate is run, corporate governance lacks any form of coherence either empirically or theoretically (Pettigrew, 1992). Despite growing academic interest in corporate governance, research so far fails to offer a convincing explanation of how corporate governance works. Practices of the subject are only marginally contributed to by the research findings and theory building. Most professional developments of practice are motivated by consequences of corporate corruption and collapse. The corporate governance codes in developed nations and in emerging economies have been based on the experience and conventional wisdom of the company directors and their advisers,

but not based on the conclusions of rigorous academic research (Tricker, 2009). The importance of corporate governance is recognized by investors, regulators and other stakeholders of the company. Its influence on the long-term success of the corporation is also understood by business leaders and other stakeholders. However, the theoretical underpinnings of the subject are not strong enough to capture the reality of corporate governance as it is practiced. At present, various theoretical perspectives shed some light on different aspects of governance, highlighting some issues while leaving others in shadow. Any general theory of corporate governance is certainly a premature suggestion (Tricker, 2009). However, it is recognized the importance of carrying out more research covering broader perspectives of governance including: regulatory levels of laws and regulations; advisory levels involving voluntary codes; and, personal levels covering an individual's beliefs and behaviour.

2.4 Different Systems of Corporate Governance

The development of corporate governance is closely linked with the economic development of industrial capitalism (Chowdary, 2003). The different forms of incorporation are designed for alternate business opportunities arising with industrial development. As a result, different governance mechanisms with different governance practices also emerged around the world. Adherence to best corporate governance practices is a prerequisite for any organisation to manage effectively in the globalised market. Therefore, the examination of efficiency of the prevailing governance systems has become one of the main issues in corporate governance (Jensen, 1993, Miller, 1997).

The corporate governance system of a country is embedded in its unique history, culture, laws and economic environment. Weimber and Pape (1999) undertook a comprehensive overview of governance in the industrialised world. They define a system of corporate governance as "a more or less country specific framework of legal, institutional and cultural factors, shaping the patterns of influence that stakeholders exert on managerial decision making" (Weimer and Pape, 1999, p.152). Furthermore, they prepare taxonomy of these systems, and identify four groupings of similar corporate governance systems within industrialized countries. These are: (1) Anglo-Saxon countries (USA, UK, Canada and Australia); (2) Germanic countries (Germany, Switzerland, Sweden, Australia, Denmark, Norway and Finland); (3) Latin countries

(France, Italy, Spain, and Belgium); and, (4) Japan. They also identify eight characteristics of governance: the prevailing concept of the firm; the board system; the salient stakeholders' ability to exert influence on managerial decision making; the importance of stock markets in the national economy; the presence or absence of an external market for corporate control; the ownership structure; the extent of which executive compensation is dependent on corporate performance; and, the time horizons of economic relationships. The legal, institutional and cultural dimensions of these characteristics have provided the basis for the identification of the groupings of four corporate governance systems. For comparative purposes, these corporate governance systems are ``market-oriented" systems and ``network-oriented" systems. The main weakness of this taxonomy is its inability to pay attention to the governance systems prevailing in emerging economies. However, it provides a strong foundation to examine the main characteristics of market oriented and network oriented systems.

A characteristic of the market-oriented system is an active external-market for corporate control. By contrast, network-oriented systems have relatively stable relationships among small groups that influence managerial decision making. For example, Clark (2005) observes an outside system of market-based corporate governance prevails in the USA and UK, while an inside system of relationship-based corporate governance is found in Europe and Asia-Pacific. Clark (2005) identifies the key differences between the two systems are related to the place where the corporate monitoring and control are located, and how the applicable rules are operated by the participants. In an insider-based system, corporate governance functions are carried out by a small number of readily identifiable economic agents, such as 'main banks' or large parent firms. The corporate control events are subject to a high degree of internal regulation by the key parties concerned, including incumbent management. In market-oriented systems, a diverse set of monitoring and control mechanisms, particularly external control mechanisms are applied. Hence, a key distinction between the two systems is made in terms of who plays the dominant role in monitoring and control of the company's affairs.

Although the systems of governance are designated either as market-oriented or network oriented systems at the highest level of abstraction, the literature on corporate governance identifies the existence of diverse governance systems around the world

(Denis and McConnell, 2003, Bhasa, 2004b, Jansson, 2005, Murphy and Topyan, 2005). For example, Bhasa (2004b) identifies four different systems of corporate governance viz.: outsider system (market-centric model); insider system (relationship-based model); transition model; and, emerging governance model. These models are widely different in terms of monitoring and control, and how those associated are accountable in the process of the separation of ownership and control within the organization. These different systems of corporate governance are discussed in subsequent sections.

2.4.1 Market Based Systems (Anglo-Saxon Model)

The market centric economies are largely characterized by: the existence of a widely held ownership structure; highly liquid stock markets due to good investor protection; and, control of companies by professional managers on behalf of the scattered shareholders (Bhasa, 2004b). In these economies, corporate managers have more power to make decisions. As the power of shareholders to select directors and vote on key issues of the company is limited by the fragmentation of ownership, regulatory bodies have to offer adequate shareholder protection and an equal access to information. Consequently the main concern of corporate governance is the conflict between strong managers and weak dispersed shareholders, and in this spirit the roles of directors, stock options, takeovers, and minority shareholder protections are frequently investigated by researchers (Gay, 2002, Denis and McConnell, 2003, Jansson, 2005). Since the managers are not the owners of the firm, they can have other objectives rather than maximizing shareholder wealth (Jensen and Meckling, 1976, Prowse, 1998b). This may give rise to agency costs. Jensen and Meckling (1976) claim that agency costs are to be incurred to align the interests of the managers with those of the shareholders. Agency costs consist of three different components: monitoring costs, bonding costs and residual loss. Monitoring costs are the control costs incurred by the principal to mitigate the devious behaviour of the manager. Bonding costs are incurred to ensure that the manager takes decisions beneficial to the principal. Residual loss occurs when both the above kind of costs fail to control the divergent behaviour of the manager. The voting control is not concentrated in a few hands in these economies as the shareholdings are widely dispersed. The ultimate authority to determine corporate strategy and to appoint members of the board rests with a large number of anonymous investors, not with a single or a small group of dominant investors. This system of corporate governance

could be seen in countries such as United States, United Kingdom, Australia and New Zealand.

In this system, dispersed investors require reliable and adequate information flows in order to make informed investment decisions and therefore this model is recognized as a disclosure-based model. Regulation is intended to ensure all investors remain fully informed and to prevent privileged groups of shareholders sharing information amongst themselves. The board of directors should have some degree of independence from management, as it is responsible for monitoring managerial performance. However, board independence often poses a problem in reality and the board is regarded as a relatively weak governance device (Denis and McConnell, 2003, Hillman and Dalziel, 2003). Thus, in the market-oriented system the capital markets play a primary role in corporate governance. When managers fail to maximize the firm's value, they expose it to the threat of a take-over; the market for corporate control may be a more effective disciplinary device than either the monitoring by institutional investors or boards of directors (Hillman and Dalziel, 2003, Murphy and Topyan, 2005). Thus this model is termed the "market-based" or "market-oriented" system of corporate governance. Gay (2002) identifies the following features as key characteristics of a market-based system: exercise of more influences by the shareholders than other stakeholders in managerial decision making; existence of a one-tier board of directors; playing important role by stock markets; existence of active market for corporate control with frequent takeovers; widely disperse ownership; availability of performance based compensation schemes for executives; and, close monitoring of company performance on short term basis.

However, even within the market based governance systems differences are evident depending on the legal systems of individual countries. According to Tricker (2009) a basic distinction has developed in recent years between the US model of corporate governance and that of the UK/Commonwealth model. The US model is fundamentally 'rule based' where as UK/Commonwealth model is 'principle based'. In the US governance is regulated by mandatory rules and therefore directors face legal penalties for non-compliance. This emphasis of governance is further strengthened with the introduction of the Sarbanes-Oxley Act in 2002. In the USA, the board of directors is entrusted with an important responsibility to monitor the company on behalf of the

shareholders. Therefore, attempts have been made to introduce a majority of non-executive directors on to the board. Further, board committees are established to enhance the oversight function of the board and limit the powers of the CEO. The board committees are usually appointed to oversee the nomination of new board members, remuneration of executive directors, and auditing (Hillman and Dalziel, 2003, Murphy and Topyan, 2005).

In contrast, jurisdictions such as the UK and Commonwealth countries have adopted Codes of Corporate Governance-benchmarks. The codes play a beneficial role due to their flexibility compared to mandatory rules. The UK is the first country to develop a corporate governance code i.e. Cadbury Code in 1992. This is followed by Hampel Report in 1998 and Combined Code in 2003. Since, corporate governance in the UK remains linked to the notions of a unitary board and the primacy of the shareholder. Codes of corporate governance principle determine board responsibilities, not the rule of law. Companies are required to report that they have followed the principles, or otherwise state the reasons for their non-compliance. Thus this model is often referred to as the 'comply or explain' model of governance (Loke, 2002, Tricker, 2009).

2.4.2 Network-oriented System (Relationship-based Model)

The insider system of corporate governance, which is common in continental Europe and some Asian counties such as Japan and Korea, is characterized by highly concentrated shareholdings, concentrated voting power, cross corporate shareholding and inter-firm relationships (Maher and Andersson, 2000). In the relationship-based model, more diverse groups of stakeholders are actively recognized including employees, customers, banks, local communities and national governments. The main feature of ownership is the dominance of financial institutions. Banks dominate the ownership shares by holding large amounts of equity in companies. They become directly involved in the operations of the firms in terms of monitoring and decision-making, etc. Banks are committed to saving companies that are in financial crisis. Hence, the governance model is largely known as a relationship-based model (McCauley and Zimmer, 1994, Becht and Roell, 1999, Gay, 2002, Bhasa, 2004b). It is possible to see long-term large shareholdings in these companies. These long-term large shareholders give a degree of protection to the company from both the stock market and

the threat of takeover. Substantial cross ownership between firms is a main characteristic of this model. Bhasa (2004a) recognizes *Jananese keiretsu*[3]*, Korean chaebol*[4]*, French verrouillage (complex network of cross-shareholding)* and *German relationship investing model* as the glaring examples of this governance model.

In many European Countries a key feature is the concentration of ownership. La Porta et al. (1999) show that in most European counties, ownership and control are held by cohesive groups of insiders who have long-term stable relationships with a company. The groups of insiders tend to know each other well and have connections with the company in addition to their investments through: family interests; allied industrial concerns; banks; or, holding companies. For instance large French companies are usually dominated by controlling shareholders, and the relationships between these companies and the state remain significant (Bhasa, 2004a). The large French companies are not primarily financed by outside capital market investors, but through family, the banks and the state. Further, a relatively strong concentration of ownership of individual enterprises is seen in German companies too. Though the ownership is shared by different groups of investors—banks, investment institutions, companies, government etc., yet banks control more of the corporate activities (Shleifer and Vishny, 1997, La Porta et al., 1999, Bhasa, 2004a). Hence, many of the legal and non-legal aspects of Anglo-Saxon corporate governance are absent, or unimportant, in these countries.

A dominant corporate governance regime in the Asian Region is Japan. From a Japanese perspective, corporate governance by definition rests with the conduct of board of directors who are appointed to run the company on behalf of shareholders. The Interim Report of the Corporate Governance Committee of the Corporate Governance Forum of Japan (1997, p.1) states "The directors are entitled to govern the company, and to supervise and monitor the company's management in order to promote effective management and ensure prudent accountability to the shareholders. The board of directors therefore is the primary overseer in the company, monitoring management to

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[3] A set of companies with interlocking business relationship and shareholdings

[4] A large conglomerate of family-controlled firms of South Korea characterized by strong ties with government agencies

ensure that it is a) always endeavouring to maximize corporate value in long term for the shareholders, and b) always prepared to be accountable its actions to all the stakeholders and - in particular - to the shareholders.” Hence, Japanese corporate governance principles have been developed with a view of firmly establishing the governance powers of directors. In the Japanese model special emphasis is placed on the shareholders and on the board of directors, who function simultaneously as shareholders’ delegates and as promoters of the benefits of all concerned shareholders. Two pivotal elements of the Japanese system are the important role played by ‘main banks’ and large parent firms, and the high degree of interlocking shareholdings, as they are the building blocks of the insider-based system of corporate governance (Aoki, 1990, Fukao, 1995).

According to Bhasa (2004a) the Japanese system relies heavily on trust and relationships. Japanese companies experience a lower cost of capital, which is assumed to be the result of close relationships between corporations and banks and other long-term investors (McCauley and Zimmer, 1994, Fukao, 1995), consequently Japanese firms have higher return of investment than their U.S. counterparts (Prowse, 1998b). The conventional Japanese model consists of a dual structure: the board of directors, which carries out the functions of strategic decision-making, and the board of auditors, which audits management’s execution of business activities. Although the board of directors carries out decision making functions they do not have real decision making powers. Instead decisions are taken by the ‘management board’, or by the ‘management board of directors.’ Most members of the board of directors are ‘executive’ directors and therefore are often ‘employees’ of the company (Cooke and Sawa, 1998, Aoki, 1990, Fukao, 1995). When discussing the Japanese corporate governance systems two main notable differences from the Anglo-Saxon model can be witnessed. They are (1) the Japanese system is based on the concept of the company as a community in contrast to Anglo-Saxon model which is based on the concept of the company owned and governed by shareholders, and (2) the Japanese system is seeking profits for ‘pluralistic-oriented’ constituencies in contrast to Anglo-Saxon system which is seeking profits for ‘individualistic-oriented’ shareholders.

According to Nestor and Thompson (2002) the difference between market-based and relationship-based systems of corporate governance is that the former emphasizes

competition and market processes, while the latter emphasizes cooperative relationships and reaching consensus. Further, they argue that the agency problem in the relationship-based system is much less severe, as insider groups continuously monitor management. In a relationship-based system, banks and other financial institutions often have complex and long-standing relationships with companies, rather than having arm's length relations with equity markets. Hence, in contrast to the heavy emphasis on public disclosure in market-based systems, the insider system is based on a deeper, but more selective, exchange of information amongst insiders. Such different structures of separation of ownership and control under these systems lead to different solutions for governance issues. While agency problems in the USA seem to stem from conflicts of interest between managers and dispersed shareholders, in Europe conflicts of interest lie between controlling shareholders and powerless minority shareholders (Shleifer and Vishny, 1986). Maug (1998) investigated whether higher market liquidity which is normally a characteristic of Anglo-Saxon countries, enhances the performance of firms. He finds that in a highly liquid market, shareholders who receive adverse information about a firm are able to sell their shares quickly, and in doing so put more pressure on managers to perform better. However, in European countries, where market liquidity is relatively low, shareholders are forced to hold on to their investments. However, due to concentrated ownership, they are able to use their voting power to influence a company's management to achieve better performance. Renneboog (2000) finds that dispersed ownership leads to free-riding on control where as strong concentration in ownership limits this effect. He further explains that when firm performance is poor, the presence of large shareholdings is followed by higher board turnover. However, disciplining of underperforming management is accomplished by large shareholders with superior monitoring abilities. Consequently, management enjoy dominant power in market-centric economies. The market-centric and relationship-based models have been widely discussed in governance literature providing evidence as to how the differences in economic characteristics and governance structures of companies bring about different performance implications. However, only limited studies have been carried out within the Asia–Pacific governance system in this respect.

2.4.3 Emerging Governance Model

While an increasing body of literature refers to the potential economic, social and cultural differences between emerging and developed markets, less discussion is

available with respect to the emerging corporate governance model. These economies are characterized by the existence of a lively capital market; successful transition of state held specialty sectors to widely-held firms; the existence of both relationship-based and market-centric governance mechanisms; the existence of formal and functional legal systems; and, the existence of both family-held as well as widely-dispersed firms (Claessens et al., 2000, Khan, 2003, Bhasa, 2004a, Bhasa, 2004b). The emerging market model has arisen as a result of attempts to impose and replicate aspects of both the relationship-based and market-based governance models into emerging economies (Bhasa, 2004b). Researchers have attempted to understand this model in the light of relationship-based and market-based governance models, and therefore country-specific characteristics of this model and their implications are largely unexplored (Zingales and Rajan, 1998, Bhasa, 2004b).

Countries of the Asia-Pacific have rich cultural diversity, with different political and legal structures, and social traditions. Therefore, significant national differences are seen in corporate governance policy and practice among companies in the Asian region. Furthermore, most of the large corporations in this region are owned and controlled by families, with family members holding key managerial positions (Nam and Nam, 2004). Therefore, the agency problem exists not between the management and owners, but between the management (the controlling family) and minority shareholders. Prowse(1998a)shows that the most common company form is the diversified conglomerate that is controlled and managed by a single extended family. Companies with widely dispersed ownership are rare in Asia. In this context, it is difficult to protect the rights of minority shareholders. Although there are laws and penalties against insider trading and related party transactions, it is open to question how often and how rigorously these laws are enforced. Therefore, in this context the relevance of both separation of ownership and control, and the principal-agent relationship is questionable. In Asian countries majority shareholders usually dominate boards. Furthermore, institutional shareholders and fund managers are not sufficiently active in corporate control, and therefore they do not play a lively role in the governance mechanism. However, banks and other financial institutions do play a dominant role in companies, as a major supplier of corporate finance. Therefore, they take a role in ensuring companies follow corporate governance principles and implement prudent financial controls.

A survey conducted by the Association of Chartered Certified Accountants (ACCA) (2002) examines the attitudes of Chief Financial Officers (CFOs) to corporate governance in China and South East Asian Countries. The findings show that there is a heightened awareness in the South East Asia region of the relevance of sound corporate governance for corporate success. Asian CFOs perceive that their performance relative to international benchmarks is improving. However, the study particularly notes that business models in Asia are historically different from those in western economies, as majority shareholdings controlling Asian companies are usually single families. Family-centred shareholders tend to look after themselves, rather than acting in the best interests of minority shareholders. Further, this study reveals several notable features of governance practices in China and South East Asian Countries: CFOs are reluctant to endorse the view that the ultimate responsibility for ensuring effective corporate governance rests with the board as a whole, as executive directors are clearly identified as responsible for putting best practice in place; CFOs do not see their responsibility as going much beyond disclosure and financial reporting because while financial reporting has a high priority, the introduction of internal controls and ensuring the independence of bodies such as the audit committee are seen as less urgent by them; and, there is widespread acceptance of the importance of corporate governance and, especially, of non-executive directors, in the protection of minority shareholders. The ownership structure of many Asian companies, however, acts as a barrier to the development of truly independent non-executive directors.

Khan (2003) asserts that financing of companies in market-based systems and bank-led governance systems is dominated by corporate finance. However, he argues financing of family-based companies is normally generated from three different sources: internal family funds; external bank financing; and, equity financing. In the initial stage, larger proportion of required capital comes from the internal sources. This financing system appears to be functioning effectively at the early development stages of the business. This is due to the fact that family-based funds reduce transaction costs (Chuanrommanee and Swierczek, 2007). However, many young and attractive companies in emerging markets often find that internal funds flows are insufficient for the growth of their businesses. As a result, the role of banks in supply of finance becomes more prominent. In the third stage, external equity finance becomes the most significant source of corporate finance. However, as the transaction costs of external

funds are expensive, managers in emerging markets are often inclined to invest in assets which are able to be funded internally (Mueller, 2004).Thus, Khan (2003) claims that neither the banks nor equity markets ultimately control the family business group in Asia.

The transition from family-based financing to equity-based financing continues to be a challenge for most stock exchanges in Asia (Chuanrommanee and Swierczek, 2007). According to The World Bank and the IMF, governance weaknesses, especially the Asian way of doing business, are a cause of the 1997 Asian financial crisis. The IMF reform programme for the crisis-affected Asian countries suggests that Asian countries should abandon this governance model and adopt the US corporate model. However, this has been highly criticized as the US model has limited application for developing countries due to structural differences, imperfect share prices and the imperfect market for corporate control (Singh and Zammit, 2006).

2.5 Globalization of Corporate Governance: Convergence or Contextualization?

Globalization and the increasing volume of Foreign Direct Investment (FDI) flow into developing countries have led to a debate around the importance of converging corporate governance systems. FDI is an important international issue due to shareholders and other stakeholders now being global, rather than local. As a result, studies in search of an optimal system of corporate governance receive much attention among corporate governance scholars over the last two decade ((Carati and Rad, 2000, Reed, 2002, Ratnatunga and Mohamed, 2005, Goergen et al., 2008). Is there an optimal system of corporate governance? Are national governance systems effectively converging towards a particular system of corporate governance? Can one governance system outperform other systems economically? These are the questions receiving much attention from those who focus on economic efficiency (or performance implications) of different governance systems. Increased cross-border contact between corporations has generated very compelling debate about the convergence of corporate governance practices. However, there are competing models about the effects of globalization on corporate governance. Ahunwan (2003) summarizes three models in this regard, namely, the convergence model, the path-dependence model and the hybrid model. According to convergence theorists, economic efficiency of globalization will

ultimately pressure global corporate governance towards a single model. Further, convergence theorists claim that the governance structures and behaviours around the world would converge into a single model either in terms of the rules and forms, or in terms of the functions (Coffee, 1999, Hansmann and Kraakman, 2001, Goergen et al., 2008). However, proponents of the path-dependent model argue that because of the evolution of corporate governance systems is path-dependent, the legal and institutional limitations, national history trajectories and peculiarities of social and cultural aspects countries would prevent governance systems converging towards a single model (Bebchuk and Roe, 1999). The theorists of a hybrid model take the middle path, and argue that while global corporate governance is unlikely to converge into a single model, it extracts best practices from different models of corporate governance (Carati and Rad, 2000).

Analysis of advantages and disadvantages of each model triggers debate around convergence of corporate governance practices (Gordon and Roe, 2004). It is observed that the impact of national governance systems on corporate performance varies. Therefore, one should expect that market competition would eventually bring about a convergence between systems (Goergen et al., 2008). According to Blair (2002) changes in corporations' performance in countries does from time to time change the focus on corporate governance systems. During late 1980s and early 1990s corporate governance studies focused on Japanese and German systems, as the companies of these countries were performing well in global markets. However, this trend changed in the mid 1990s towards a market-based system, due to the growth in high-technology and communication companies in USA. The Asian crises in 1997 and subsequent collapse of the Russian economy dramatizes the view that the US system of corporate governance is better than alternative systems. From mid 1990's Anglo-American corporate governance became the dominant model for large, public firms in the international business and it was adopted in many parts of the world including both developed and developing countries. However, with the collapse of Enron and other large corporations in the USA and other countries, where market-based governance systems operate, confidence was lost especially in respect of the incentive structures of corporate directors and managers and checks and balances built into the market-based governance system. Nevertheless, functional convergence towards the market-based system is occurring. It is driven by many forces such as the increasing influence of

regional stock exchanges, the accelerating convergence towards international accounting standards, and the sustained wave of international mergers and acquisitions. This functional convergence is supported by the development of international codes and standards of corporate governance by recognized international institutions such as the OECD, the IMF, the World Bank, the Asian Development Bank and other international bodies. Although all these policies usually rejected the notion of 'one size fits all', emphasize is given to the move towards more market-based systems.

However, it is noted that corporate ownership and governance structures differ, even within the most developed economies in the world (Bebchuk and Roe, 1999). What explains these differences? Notwithstanding the powerful forces of globalization some key differences have thus far persisted. And should they be expected to persist or to disappear? The proponents of path dependence theory shed some light on these issues through their theoretical and empirical analysis. Bebchuk and Roe (1999) recognize the differences of corporate ownership and governance structure that exist, even in advanced economies, background forces against global convergence. According to them, structure-driven path dependence and rule-driven path dependence play a vital role in deciding the corporate governance and ownership structure of a country. The direct effect of initial ownership structures on subsequent ownership structures (structure-driven path dependence), and the legal rules that govern the relationship between the corporation and its investors, stakeholders, and managers (rule-driven path dependence), explain the reasons for differences in governance structures around the world. Path dependence can therefore be recognised as one of the important forces shaping the corporate governance structure of a country.

This has led to another debate among corporate governance scholars as to origins of corporate governance systems, whether legal, political or other. Loke (2002) points out that the law cannot do much to build conditions for good corporate governance. It can set a number of mandatory conditions that would be conducive to effective monitoring. He argues that good corporate governance results depend upon management, controlling interests, and the discipline of the market. There is another school of thought, which says that corporate finance and governance are strongly based upon and shaped by the political and cultural outlook of a country. All these arguments are consistent with the theoretical arguments of the path dependence model.

"To assume that all countries will adapt to the same corporate governance structures is unrealistic. It is likely that fundamental features of the European or Asian approaches will be maintained, even when the apparatus of market based systems are formally adopted. Often these differences will be perceived as a part of cultural integrity and economic dynamism of the country in question. At the same time, countries will adopt the important international corporate governance codes, as there is a commitment to strive for the highest standards of governance around the world."(Clarke 2007, p.265)

2.6 Corporate Governance Codes, Best Practices and Principles

Since many governance problems result from the separation of ownership and control, a good governance framework should principally address these problems. One of the prime tasks of any governance framework is to ensure the shareholders' rights enhance the value of a firm. Thus, a governance framework should be able to provide a structure that can minimize agency costs inherent in any system. The most difficult task in this respect is to provide a proper mechanism which makes possible achievement of an optimum balance between power and accountability. Good corporate governance should provide proper incentives for the management to pursue objectives that are in the interests of shareholders, and should facilitate effective monitoring; thereby ensuring better performance of a firm. Hence, it is essential to determine best practices in corporate governance that emphasizes the duty of the board to ensure the shareholders' interests and to maximize shareholder value.

2.6.1 Corporate governance Codes and Best Practices

Davies and Schlitzer (2008, p.533) recognize corporate governance codes as "the voluntary sets of principles, standards or best practices that are related to the internal governance of businesses." The corporate governance codes recommend the role and composition of the board of directors, relationships with shareholders and top management, auditing and information disclosure, and the selection, remuneration, and dismissal of directors and top managers (Aguilera and Cuervo-Cazurra, 2004).

Most of the codes identify the quality improvement of companies' board governance and the increase of accountability of companies to shareholders, while maximizing shareholder value as the main objective of the codes. The corporate

governance codes are generally prepared by various professional institutions or government authorities. Aguilera and Cuervo-Cazurra (2004) classify the type of issuer of governance codes into six categories: (1) stock exchanges, where the issuer is the stock exchange or securities and exchange commission; (2) governments, where the issuer is the central or federal government or one of its ministries; (3) directors' associations, where the issuer is an association of directors; (4) managers' associations, where the issuer is an association of managers; (5) professional associations, where the issuer is an association of accounting or law professionals; and (6) investors' associations, where the issuer is an association of investors. They further argue that codes are developed in response to a combination of endogenous and exogenous pressures to solve deficiencies in a country's corporate governance system. According to them, internal pressures aim to increase efficiency in the system, and exogenous pressures seek to acquire legitimacy. Therefore, content of the code varies across countries. Further, they have argued that it is important to understand the issuers of codes in their different national contexts because identifying these issuers provides critical information regarding reasons for development of the codes, and the strength of their enforceability.

There is no single system of good corporate governance acceptable to all, owing to various differences. As described in Section 2.4 and 2.5, different legal systems, institutional frameworks, economic conditions and traditions have resulted in developing different corporate governance approaches around the world. Despite these differences, countries with effective corporate governance systems become attractive to both domestic and foreign investors and therefore most of the countries promote best governance practices through corporate governance codes (Aguilera and Cuervo-Cazurra, 2004). Furthermore, a number of international agencies have taken a pro-active role in promoting sound corporate governance standards and principles over the last decade. The OECD was the first international body to establish an inter-governmental task force in order to produce a set of globally acceptable principles of corporate governance (Solomon and Solomon, 2004). The OECD principles provide a framework in developing and establishing a corporate governance system and practices of a country in accordance with its own legal, institutional and regulatory environment (Frederick, 1999). Thus, these principles have significantly influenced the development of corporate governance codes by various countries.

2.6.2 OECD Principles of Corporate Governance

OECD Principles (1999) represent the first initiative by an inter-governmental organisation to develop the core elements of a good corporate governance system and principles. The development of these principles has led the way in creating an international corporate governance code. Hence, the governments could use these principles as a benchmark to evaluate and improve their national rules and regulations. These principles highlight five broad areas of corporate governance, which are essential to any sound model of governance. They are: the rights of shareholders; the equitable treatment of shareholders; the role of stakeholders; disclosure and transparency; and, the responsibilities of the board (OECD, 1999b). These principles are described in subsequent paragraphs.

The rights of shareholders include the right to: ownership registration; convey or transfer shares; obtain relevant information on the corporation in a timely and regular way; participate and vote in general shareholder meetings; elect members of the board; and, share in the profits of the corporation (OECD, 1999b, p.17). The equitable treatment of all shareholders including minority and foreign shareholders is also recognised as the important principle. As per this principle, all shareholders should have the opportunity to obtain effective redress for violation of their rights. All shareholders of the same class should be treated equally. Insider trading and abusive self-dealing should be prohibited, and members of the board and managers should be required to disclose any material interests in transactions or matters affecting the corporation (OECD, 1999b, p.19).

The OECD principles (1999) state that the corporate governance framework should recognize the rights of stakeholders as established by law, and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises. It specifically covers the following: "the corporate governance framework should assure that the rights of stakeholders that are protected by law are respected; where law protects stakeholder interests, they should have the opportunity to obtain effective redress for violation of their rights; the corporate governance framework should permit performance-enhancing mechanisms for stakeholder participation and where stakeholders participate in the corporate governance process, they should have access to relevant information." (OECD, 1999b, p.20)

"The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding corporation, including the financial situation, performance, ownership, and governance of the company. Disclosure should include, but not be limited to, material information on the financial and operating results of the company, company objectives, major share ownership and voting rights, members of the board and key executives, and their remuneration, foreseeable risk factors, issues regarding employees and other stakeholders, and governance structures and policies. The information should be prepared, audited, and disclosed in accordance with high quality standards of accounting, financial and non-financial disclosure, and audit."(OECD, 1999b, p.21) An independent auditor should conduct an annual audit in order to provide an external and objective assurance on the way in which financial statements have been prepared and presented.

The responsibilities of the board state that "the corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders."(OECD, 1999b, p.22) Thus, the "board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders;"(OECD, 1999b, p.22) treat all shareholders fairly where board decisions may affect different shareholder groups differently; ensure compliance with applicable law and take into account the interests of stakeholders; fulfil certain key functions such as reviewing and guiding corporate strategy and major plans of action; "selecting, monitoring and replacing key executives, and overseeing succession planning; reviewing key executive and board remuneration, and ensuring a formal and transparent board nomination process; monitoring and managing potential conflicts of interest of management, board members and shareholders; ensuring the integrity of the corporation's financial reporting systems;"(OECD, 1999b, p.22) and monitoring the effectiveness of the governance practices; and the board should be able to exercise objective judgement on corporate affairs independent, in particular, from management. "In order to fulfil their responsibilities, board members should have access to accurate, relevant and timely information."(OECD, 1999b, p.23)

Since these principles were first issued in 1999, they have gained worldwide recognition as an international benchmark for sound corporate governance. They are

actively used by governments, regulators, investors, corporations and stakeholders in both OECD and non-OECD countries (Frederick, 1999). The principles introduced in 1999 were revised in 2004 to response to corporate governance developments and experiences of both OECD member and non- member countries. Accordingly, these principles have been advanced in three main areas: ensuring the basis for an effective corporate governance framework which was before largely implicit; the effective exercise of ownership; and dealing with conflict of interest. Since corporate governance weaknesses in many non-OECD countries, especially emerging markets have been attributed to lack of effective ownership; special emphasis is placed on the protection of shareholders' rights.

2.7 Measurement of Corporate Governance Practices

To encourage the implementation of the best corporate governance practice, various institutions have developed corporate governance indexes to rank companies by the level of compliance to best practices. However, these indexes vary in terms of their focus and coverage. In previous studies, various proxy variables are used to assess the level of compliance to corporate governance practices and these variables are recognised under different aspects of corporate governance such as: board structure; board procedure; audit committee practices; directors compensation; shareholders' rights; and, related party transactions (Balasubramanian et al., 2007); board structure; stewardship; strategic leadership; capital structure and market relations; and, social responsibilities (Ho, 2005); and presence of independent directors; availability of audit committees; conduct of the external audit; and the percentage of shares held by outsiders and insiders (Susilowati et al., 2005). Furthermore, the professional associations and rating agencies have also developed governance indices covering a broad range of areas. The variables and coverage of these indexes are discussed in the following section.

2.7.1 Governance Indexes of Professional Rating Services

Professional ratings agencies come up with various governance rating methodologies which are capable of measuring governance scores of companies. These scores provide the basis for rankings and evaluating effective implementation of best governance practices. They include Governance Metrics International Rating (GMI,

2010)[5], the corporate governance Quotient of the Institutional Shareholders Services (CGQ, 2010)[6], the Corporate Governance Score of Standard and Poor's (CGS, 2010)[7] and the Board Effectiveness Rating (BER, 2010)[8] of the Corporate Library. Most of these rating services obtain required data for developing rating scores from the publicly available sources. These rating systems are developed covering the aspects and determinants of governance mechanisms such as board characteristics, ownership structure etc. Allen et al. (2004) analysed aspects included by these governance rating systems, as shown in Table 2.1. These governance ratings focus on several general categories namely; board characteristics, ownership structure, compensation plans, anti-takeover devices, financial disclosers, internal control and director education (Donker and Zahir, 2008).

Diverse variables are considered under each category by these rating systems. Although considerable differences exist in respect of the number and the nature of variables under each of these categories by different rating systems, it is possible to identify common characteristics of concepts upon which these variables are derived. For example, the variables under board structure and accountability focus on common principles or concepts of: independence of board members; board size; board members' attendance; chairman/CEO separation; directors serving on boards of other companies; composition of audit committees; nominating committees and compensation committees; annual election of the board of directors; disclosure of corporate governance guidelines; code of conduct and ethics; and, share ownership of executive directors.

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[5]GMI, a US based rating organisation, was formed in April 2000 to monitor corporate governance and presently provides GMI Ratings for over 4,200 companies.

[6]Institutional Shareholder Services (ISS) was founded in 1985 with the goal to promote good corporate governance in the private sector. In 1986, ISS launched its Proxy Advisory Service to assist institutional investors in fulfilling their fiduciary obligations with comprehensive proxy analysis. Risk Metrics Group acquired ISS in January 2007.

[7]Standard & Poor's (S&P), a US based credit-rating agency, began to develop methodology to benchmark corporate governance in early 1998. Governance Services unit of S&P launched a corporate governance scoring service in 2000. Standard & Poor's ratings have been used in many research studies.

[8]The Corporate Library is an independent research firm focusing on corporate governance. The firm was founded in 1999, and continues its focus on corporate governance matters.

Table 2.1 Categories of Corporate Governance Rating Systems

	Institutional Share Holder Services (ISS)	Standard and Poor's (S&P)	Governance Metric International (GMI)	The Corporate Library (TCL)
Rating	Corporate Governance Quotient (CGQ)	Corporate Governance Quotient (CGQ)	Governance Metric International (GMI)	Board Effectiveness Rating (BER)
Variable and Categories	61 Variables in 8 Categories	Over 80 criteria in 4 Categories	600 Variables in 7 Categories	6 Categories
Number of scores	Overall Plus 8 Categories	Overall Plus 4 Categories	Overall Plus 7 Categories	Overall Plus 6 Categories
Categories				
1	Board structure and compensation	Board structure and effectiveness	Board accountability	Board structure and make-up of skills
2	Executive and director compensation	Shareholder rights and stakeholder relation	Executive compensation	CEO compensation contracts and compensation practices
3	Director and officer stock and ownership	Ownership structure and influence	Ownership base and potential dilution	Outside director shareholdings
4	Charter and by-law provisions	Financial transparency, disclosure and audit	Financial disclosure and internal control	Ownership
5	Audit		Market for control	Accounting and audit oversight
6	Takeover practice		Reputational and socially responsible investment issues	Board decision making
7	Director education		Shareholders' rights	
8	Qualitative factors			

Source: Allen et al., 2004, p. 40; (Modified)

Variables included in the directors' compensation category include: the level and form of compensation; performance evaluation criteria; independence and integrity of the compensation setting process; shareholder approval of the compensation policy; pension plans; stock options policy; and, company loans to directors etc.

In shareholder rights categories, issues include: a one vote system; ability to amend the charter or bylaws with a simple majority vote of shareholders; ability to call special meetings by shareholders; the presence of a majority shareholder; and, staggered board appointments. The number of variables considered under each category varies considerably across alternate rating services. However, it is common practice for many of the rating systems to give high scores for governance practices which are usually considered good practices, such as having a high proportion of independent members on the board, high member attendance at meetings etc. despite the fact that these have not necessarily been shown to improve company performance (Bhagat and Jefferis, 2002).

In contrast to other ratings services, Standard & Poor's score corporate governance for both individual company and countries. The Corporate Governance Score (CGS) of a company focuses on the internal governance structure and processes at an individual company and it reflects the assessment of a company's corporate governance practices and the extent to which these serve the interests of the company's financial stakeholders, with an emphasis on shareholders' interests. The country governance assessment discloses the effectiveness of the legal, regulatory, information and market infrastructure of a country, and it reflects how external forces at a macro level influence the quality of a company's corporate governance (Standard & Poor's Governance Services, 2004). The corporate governance analytical framework of Standard & Poor's is given in Table 2.2. The company level governance practices and policies are measured against pre-determined corporate governance criteria and related analytical issues which have been developed based on a synthesis of international codes, governance best practices and guidelines of good governance practices. It employs a numeric scale for its corporate governance scores on a 1 to 10 basis with 10 being the best possible score.

Table 2.2 Corporate Governance Analytical Framework

Country Analytical Structure	Company Analytical Structure	
Category	Category	Criteria
Market Infrastructure	Ownership Structure and Influence of External Stakeholders	Transparency of ownership Concentration and influence of ownership and external stakeholders
Legal Infrastructure	Shareholder Rights and stakeholder relations	Shareholder meeting and voting procedure Ownership rights Takeover defences Stakeholder rations
Regulatory Environment	Transparency, Disclosure and audit	Content of public disclosure Timing of and access to public disclosure Audit process
Informational Infrastructure	Board Structure and Effectiveness	Board structure and independence Role and effectiveness of the board Directors and senior executive compensation

Source: Standard and Poor's Governance Services, 2010; (Modified)

The corporate governance scores provide several advantages for various interested parties such as the provision of a: systematic overview of all relevant issues of good governance for investors and analysts, a basis for analysing quality of governance; and, set of scores to investors allowing them to set minimum scores in controlling policy of their general investment portfolio (Donker and Zahir, 2008).

However, there is no one model of corporate governance that works in all countries as it a product of political, legal, cultural and social systems of the country. Having recognized the advantages and relative nature of governance structure, various institutions have made attempts to develop governance indexes suitable for different contextual settings.

Wakasugi et al. (2003) of the Japan Corporate Governance Research Institute have developed the Japan Corporate Governance Index (JCG Index), based on a mail questionnaire survey carried out among all firms listed on the Tokyo Stock Exchange. The JCG Index was developed using 201 responses received out of 1523 listed companies. It covers four main sections: corporate objectives and CEO responsibility; structure and function of board of directors; management system; and, transparency and communication to shareholders. The seven main governance principles underlay the JCG Index, namely; governance by the shareholders; clear and measurable corporate goals; a system to assure the responsibility of the CEO and top management team for realizing the goals; an independent board with capability to monitor and motivate management; systems for managerial decision-making; implementation, and risk-management; accountability to shareholders through providing timely and sufficient information and securing shareholders' trust through investor relations activities; and, maintenance of transparency through disclosure to all stakeholders. Based on survey responses, the JCG index reports the degree to which a firm adheres to these principles on a scale of 1 to 100 points. They further analyse the relationship between the JCG Index and corporate performance, and find that high JCG Index firms achieved superior performance as measured by ROA, ROE, stock return and employee growth.

The Conference Board Canada (2000) has produced 'The Governance Index' to rate the boards of companies. It covers three main sections: responsibilities assumed by the board; independence from management; and, effective functioning of the board and its committees. This is a self assessment questionnaire and any board member of a firm can use this to rate the effectiveness of the board. Seventeen questions are raised under board responsibility and seven each under independence and effective functioning of the board. Each of the three sections should be marked separately by scoring one point for each 'yes' response. The three sub-totals should be added for a final index score, and they are rated in terms of their score.

Credit Lyonnais Securities Asia (CLSA)[9] (2001) produced its first report on corporate governance for global emerging markets, covering 115 of the largest companies in 25 emerging markets in 2000. This is based on a questionnaire survey among its analysts in each country, for the companies that they cover. In 2001, another survey with a larger sample of 495 companies covering the emerging markets of Asia, Latin America, Eastern Europe, Middle East and Africa was conducted, with a revised questionnaire which included 57 questions requiring only binary answers (yes/no), to reduce analyst's subjectivity. The questions related to main aspects of corporate governance grouped under seven categories: management discipline; transparency; independence; accountability; responsibility; fairness; and, social responsibility. A composite governance rating is computed by giving an equal weight of 15% to the first six categories and a weight of 10% to social responsibility. The key findings of the study show that there is a high correlation between corporate governance and financial ratios, valuations and share-price performance of companies with larger market capitalization.

2.7.2 Corporate Governance Regulation Indexes

The economic effects of corporate governance regulation have received much academic attention in recent years. La Porta et al. (1998) investigate empirically the relationship between law, economic growth and governance of firms. They develop the tools that enable researchers to compare institutional environments across countries and to study the effects of corporate regulation. These tools comprise of a country classification by legal origin, and indices that characterize the quality of regulation in protecting the rights of shareholders and creditors. In this study corporate governance indices are constructed using a comparative approach. Legal systems of different countries are comparing with US corporate law, which is used as the reference legal system. The key legal provisions in the governance of US companies are compared with similar provisions present in the law of other countries. It is therefore, the countries with legal systems most closely resembling that of the US that receive the highest score on the rating. The main weakness of this approach is that it ignores the regulatory

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[9]CLSA is an Asia's leading, independent brokerage and investment group. The company provides equity broking, capital markets, merger and acquisition, and asset management services to global corporate and institutional clients. Survey conducted in 2001 rates corporate governance practices of 495 companies covering 25 countries and this survey is quoted in several research papers.

principles that prevail in other countries, but not in the US. The main objective of the corporate governance system in the US, which is commonly known as a shareholder-based system, is to protect corporate investors from being expropriated by the firm's management. However, most European and Asian countries where stakeholder-based governance systems are implemented the expropriation of investors by the management is naturally prevented via monitoring by the firm's larger shareholders, creditors or employees. Therefore, the address of this problem takes less attention at the regulatory level in those countries.

A corporate governance system is a broader concept than corporate governance regulation. Governance system of any country covers a broader set of institutional settings such as the quality of legal protection of corporate communities, concentration of ownership and control and the development of capital markets etc. The governance regulations of a country therefore, have to be evaluated in comparison with a national governance system. Martynova and Renneboog (2007) developed new governance regulation indices to reflect the quality of national regulations in protecting better number of stakeholders groups: namely, (i) corporate shareholders from being expropriated by the firm's management, (ii) minority shareholders from being expropriated by the large block holders, and (iii) creditors from being expropriated by the firm's shareholders. This study employs functional approach instead of comparative approach and identifies all major provisions of corporate laws by country and classifies them according to the degree of protecting the rights of above mentioned stakeholder groups. Three governance regulation indices have been constructed: namely, (i) the shareholder rights protection index, (ii) the minority shareholders protection index and (iii) the creditor rights protection index. The variables for each of the indices have been identified based on the regulatory provision of the law system of the country. This study provides a comprehensive comparative analysis of corporate governance regulatory systems in 30 European countries and the US. The indices indicate how the law in each country addresses various potential agency conflicts between main stakeholder groups. The analysis of regulatory provisions within the country itself provides better understanding as to how corporate law works in a particular country and which strategies regulators adopt to achieve their goals.

2.8 Ownership and Level of Corporate Governance

The literature on the relationship between ownership and corporate governance is widespread. Much of corporate governance theory is focused on the Berle and Means Hypothesis (1932) of the separation of ownership and control. According to them the most prevalent form of corporate entity is the widely held corporations, in which ownership of capital is dispersed between small shareholders and control is concentrated in the hands of managers. However, La Porta et a1. (1999) study on corporate ownership around the world based on 27 wealthy economies sets out some useful factors on corporate ownership that differ from the original idea of Berle and Means proposition. According to this study the separation of ownership and control in listed public companies suggested by Berle and Means proposition is not common in most countries. Further, it finds that many of the largest firms are controlled by families, widely held firms is most common in countries with good shareholder protection and family and state control are more common in countries with poor shareholder protection. There is little separation between ownership and control in family controlled firms. Demtez and Lehen (1985) also state that substantial amount of publicly held corporations are characterised by concentrated ownership. Further, Shleifer and Vishny (1997) state that concentrated shareholdings and a predominance of controlling ownership rule the world.

The shareholding patterns of companies have a significant influence on their governance. Shlefier and Vishny (1997) state that in companies which are managed by professional managers, large shareholders play an active role in corporate governance. In companies, which are controlled by owner-managers, the issue is how to monitor and control owner-managers. La Porta et a1. (1999) state that it is important to recognise the exception to widely held corporations to understand corporate governance in most of the countries in the world. They point out that in many economies the primary agency problem is that of restricting expropriation of minority shareholders by the controlling shareholders rather than that of restricting the activities of professional managers unaccountable to shareholders. This is a common issue for most companies in the emerging markets. For example, Bhattacharyya (2004) states that in India, companies are continued to be managed by promoter-managers and financial institutions exercise a passive control. Therefore, he suggests that Indian companies should have an effective internal monitoring system as in this context the agency conflict usually arises not

between owners and managers but between controlling shareholders and minority shareholders.

Gillan and Stark (2003) consider the role of institutional investors in corporate governance and show that the institutional investors, often-foreign institutional investors play a central role in promoting change in many corporate governance systems. They also show that the foreign investment plays an important role in corporate governance of a firm as the firms are motivated to improve their corporate governance in order to attract foreign capital. On the other hand, increased investment by foreign institutions provides those institutions with the power to enforce governance changes in firms in which they invest. In addition to direct intervention by foreign investors, indirect supply-demand effects have also led to improved governance. This evidence suggests that there is a relation between the foreign ownership and the level of corporate governance standards in a firm. Mitton (2002) suggests that during the 1997 Asian financial crisis firms with more concentrated ownership had better stock price performance. Black (2001) provides that a correlation exists between the market value and corporate governance of Russian firms. Gillan and Stark (2003) also highlight that numerous factors influence governance of companies. These factors include board of directors, financing arrangements, law and regulations, labour contracts, and the market for corporate control.

2.9 Board Structure and Corporate Governance

The board of directors is the most important internal governance mechanism that ensures stakeholders' rights, corporate direction and accomplishment of corporate objectives, and safeguard owner's wealth. Fama & Jensen (1983) view the board as "the apex of internal decision control systems of organizations." Scholars identify several roles of the board of directors depending on deferent theories and perspectives. Two key roles emerge from internal environment perspective: conformance and performance role linking with agency and stewardship theory (Ingley and Vander, 2001). According to this view two functions of strategy formulation and policy making form performance role of the board whereas conformance role is viewed as amalgamation of two roles: providing accountability; and, monitoring and supervising of management activities. However, emphasis on the prime functions of board performance role significantly

varies across different political, economical, social and cultural context of each country (Ingley and Vander, 2001).

Johnson et al. (1996) outline three widely recognized functions of boards of directors, namely the control, service and resource dependence roles. Most literature on the control function of the board draws on agency theory perspective, which recognizes the boards as the primary internal mechanism for controlling managers' opportunistic behavior, thus helping to align shareholders' and managers' interests (Jensen 1993). Service role entails directors giving strategic advice to the CEO whereas the resource dependence perspective views the board as an instrument for sourcing critical resources to create sustainable competitive advantage (Dalton & Daily 1999).

Hermalin and Weisbach (2001) point out that, there are three primary issues addressed in the empirical studies concerning board of directors. These issues are; the relationship between various board characteristics and firm performance; the impact of various board characteristics on the observable actions of the board; and, the factors that affect the makeup of boards and their evolution over time. Two characteristics of the board of directors that received much attention in the literature are board size and the relative independence of the board members. With respect to size, most studies generally hypothesize that smaller boards are more effective because they can hold more candid discussions and make decisions more quickly. Jensen (1993) argues that large boards are less effective and are easier for the CEO to control. When a board gets too big, it becomes difficult to co-ordinate and process problems.

Leblanc (2004) asserts that effective decision making by board depend upon the independence of judgment, and specific competencies and behaviours of individual directors. Sharma (2004) studied the relationship between board independence and fraud across a sample of 62 Australian listed companies. He found that the presence of independent directors on company boards, and the absence of CEO duality significantly reduced the likelihood of fraud. According to Shen (2005), non-executive directors (NEDs) are in position to contribute to achieve corporate success. Mayer, (1997) asserts that NED dominated boards add value to their corporations through CEO changes than those of insider dominated boards. Role of the NEDs differ in different contexts and contribute positively for organizational success. It is argued that NEDs play a

supervisory role and they are responsible for review of directors' decisions and solve conflicts between shareholders and directors (Solomon, et al., 2003).

Turnbull (1997) argues that both composition and the structure of the board are not significant factors in determining its effectiveness. He further argues that NEDs are constrained by lack of information independent of management; expropriation by dominant shareholders and management; and, lack of will power to act best of their ability. Hooghiemstra and van Manen (2004) conducted a survey of the opinions of Dutch non-executive directors regarding their roles in the boards and found that, although non-executive directors are expected to operate independently from management, in practice, they are unable to do so because they rely on this same group to provide them with the information necessary for decision making.

Much of the academic literature concerning corporate governance and board composition has sought to establish causal relationships between board structure and firm performance. Most theories of corporate governance have hypothesized a link between various characteristics of the board and corporate performance. Agency theory is concerned with aligning the interests of owners and managers (Jensen and Meckling, 1976) and it is based on the premise that there is an inherent conflict between the interests of a firm's owners and its management (Fama and Jensen, 1983). Thus, agency theory leads to normative recommendations that boards should have a majority of outside and, ideally, independent directors and that the position of chairman and CEO should be held by different persons (Bosch, 1995 and OECD, 1999). In contrast, stewardship theory claims that managers are essentially trustworthy individuals and therefore good stewards of the resources entrusted to them (Donaldson, 1990; Donaldson and Davis, 1994). Proponents of stewardship theory argue that superior corporate performance will be linked to a majority of inside directors as they work to maximise profit for shareholders.

The empirical studies can be found to support the predictions of both agency theory and stewardship theory concerning the relationship between the proportion of outside directors or CEO duality and corporate performance. Beasley (1996), for example, examined the 75 fraud and 75 no-fraud firms and found that no-fraud firms had boards with significantly higher percentages of outside members than fraud firms.

McNulty and Pettigrew (1999) conducted interviews with 108 UK directors and found that part-time board members did not simply ratify decisions made by all powerful executives, and were able to influence the processes of strategic choice leading to high performance. In contrast, Agrawal and Knoeber (1996) found that more outsiders on the board were negatively related to performance. A meta-analysis based on 159 samples of board composition and their relationships with corporate performance found that there is no substantive relationship between board composition and firm performance (Dalton, et al., 1998). On the other hand, in a similar meta-analysis based on 37 samples from previous studies, Rhoades, et al. (2000) concluded that the proportion of outside directors had a positive relationship with firm performance. Overall there is a general lack of consistent evidence of any significant relationship between the composition of boards of directors and corporate performance.

2.10 Corporate Governance and Firm Performance

Corporate governance is considered a performance diver of the firm and much of the discussions of corporate governance focus on the assumption that the governance mechanisms influence firms' performance (Ali El and Sound, 2008). However, there is no conclusive empirical evidence on how corporate governance mechanisms influence corporate performance. Most research examine the influence of specific aspects of corporate governance such as board of directors, directors' remuneration policy ownership structure and capital structure on firm performance (Agrawal and Knoeber,1996, Demsetz and Villalonga, 2001, Jackson and Moerke, 2005, Thomsen et al., 2006).

The prior studies regarding the relationship between various aspects of corporate governance and financial performance (or firm value) have produced mixed results. For example, Beasley (cited in Ho, 2005) carried out an analysis of 75 fraud and 75 no-fraud firms which indicated that no-fraud firms had boards with significantly higher percentages of outside members than fraud firms. However, Agrawal and Knoeber (1996) found that more outsiders on the board were negatively related to firm performance. In an attempt to reconcile these divergent evidences, Udayasankar and Das (2007) notionally explained the performance implication of corporate governance in the context of the exogenous environment supported with multiple theories of corporate governance such as agency, stakeholder, resource-dependence, and

institutional theories and argue that the regulation and competitive forces in the environment interact with the governance practices of firms resulting in idiosyncratic effects on performance. However, it is commonly perceived that good corporate governance is very important in assuring accountability and performance which provide the competitive advantages for the firms. Ho (2005) finds positive relationship between the broad attributes of corporate governance and corporate performance. The market for corporate control view emphasizes those firms with poor corporate governance standards are subject to the risk of being acquired. The resource-dependence view of corporate governance suggests that firms with better corporate governance are likely to have better access to critical resources which are essential to achieve competitive advantage (Chung-Cheng et al., 2006).

The board is the prime internal corporate governance mechanism that ensures a company takes correct corporate direction to accomplish its objectives in order to safeguard shareholders' interests. In this respect, the key roles of board consist of its conformance role and performance role (Hung, 1998). Accordingly, the functions of strategy formulation and policy making form the performance role of the board, whereas ensuring accountability, and monitoring and supervision form the conformance role. However, a single theoretic approach especially an agency theory perspective is less capable of understanding the effects of the board on firm-level financial performance since it does not capture the broad spectrum of directors' roles as a result its overemphasis on directors' monitoring and supervision role by marginalizing other roles (Jinyu and Mahoney, 2006). As a result, some empirical studies began to use a multi-theoretic framework to capture the effectiveness of the board by means of various factors such as board size, composition of independent directors in the board, CEO duality, and managerial ownership (Hillman and Dalziel, 2003). Jinyu and Mahoney (2006) develop a theoretical model based on empirical evidence of the prior research in the light of the resource-dependence, the agency and the social capital theory perspectives and identified that the board capability drivers firm-level competitive behaviour which leads to better financial performance. However, emphasis on the two prime roles of board significantly varies across different political, economical, social and cultural context of each country resulting different performance implications of board functions (Ingley and Van der Walt, 2001).

Companies do not operate isolation and therefore ability of a company to transform into competitive positions with better performance is influenced by factors such as distortions in market economy; perfect or imperfect competition; competition regulation; corporate or securities laws, trade barriers, industry norms and finance providers (Dignam, 2005). Therefore, corporate performance is largely determined by the corporate governance system of a country. For example, in the US where market-based governance system is in operation, the companies achieve better performance through liquid stock markets, venture capital and strong labour markets whereas the companies in Japan and Germany, where relationship-based system is in operation, achieve better performance through practices such as network based production models, incremental innovation and shop floor skills (Jackson and Moerke, 2005). Mourdoukoutas & Papadimitriou (1998) argue that the corporate practices lead to better performance are largely influenced by the corporate governance system and therefore practices could only be transferred to similar governance system.

2.11 Corporate Ownership and Firm Performance

The corporate governance mechanisms vary around the world resulting different ownership effects on firm performance. For example, market-centric economies are largely characterized by the existence of a widely held ownership structure, and governance of companies by professional managers on behalf of scattered shareholders (Bhasa, 2004). Therefore, corporate managers enjoy more power in decisions making process. These decisions may frequently be in their own interest resulting higher agency costs and thereby reducing overall firm performance. Hence, agency theory argues that ownership concentration may improve firm performance by decreasing agency costs (Shleifer and Vishny, 1986).

Jensen and Meckling (1976) illustrate theoretically how the allocation of shares among insiders and outsiders can influence the agency costs and firm value. Since these authors' work, the relationship between ownership and firm performance has attracted special attention. Agency theory and the empirical literature thereof usually consider insider ownership as the main corporate mechanism that increases firm value. However, empirical evidence regarding the relationship between ownership concentration and financial performance (or firm value) has produced mixed results (Agrawal and

Knoeber, 1996; Demsetz and Villalonga, 2001; Thomsen et al., 2006). Despite the existence of a wealth of research, the question of whether concentrated ownership contributes to reduced agency costs and thereby improves firm value and financial performance remains unanswered.

The agency theory hypothesis is first challenged by Demsetz (1983), who argues that the ownership structure of a corporation should be thought of as an endogenous outcome of decisions that reflect the influence of shareholders. Demsetz asserts that no systematic relationship should exist between variations in ownership structure and variations in firm performance. Demsetz and Lehn (1985) provide evidence of the endogeneity of a firm’s ownership structure, using a measure of the profit rate on a fraction of shares owned by the five-largest shareholdings, and found no evidence of any relationship between profit rate and ownership concentration. Conversely, Shleifer and Vishny (1986) show the importance of the role played by large shareholders, and how the price of a firm’s shares increases as the proportion of shares held by large shareholders rises. They argue theoretically for a positive relationship between ownership concentration and firm value.

Morck et al. (1988) ignored the endogeneity issue altogether and re-examined the relationship between corporate ownership structure and performance, measured in terms of Tobin’s Q, and propose a non-linear relationship between insider ownership and firm performance. They found a positive relationship between corporate ownership structure and Tobin’s Q for less than five per cent board ownership range, a negative relationship in the 5–25 per cent range and a positive relationship for ownership exceeding 25 per cent. However, their results are not supported by accounting-based performance measures. Wu and Cui (2002) found a positive relationship between ownership concentration and accounting profits, indicated by return on assets and return on equity, but the relationship is negative with respect to the market value measured by the price-earnings ratio and market-to-book-value ratio.

The literature extensively examines corporate governance issues under various theoretical perspectives, such as the agency, stewardship, stakeholder and political models. Most of these theories are developed and examined in the developed economies, assuming contextual conditions of these economies provide universal

reference. Tricker (cited in Turnbull, 1997, p. 187) states that “stewardship theory, stakeholder theory and agency theory are all essentially ethnocentric. Although the underlying ideological paradigms are seldom articulated, the essential ideas are derived from Western thought, with its perceptions and expectations of the respective roles of individual, enterprise and the state and of the relationships between them”. An increasing body of literature refers to the potential differences in the economic characteristics of developing countries. However, the interaction of these economic characteristics with governance and ownership structures, and the performance implications of these factors have not been examined thoroughly. Therefore, these contextual differences across countries create another dimension to the ownership structure and performance issue.

Because of the contextual differences across countries, different relationships between ownership structure and firm performance might be expected. For example, in emerging economies, where firm ownership is highly concentrated with family ownership, a significant positive effect of ownership concentration on firm performance is proposed. This argument is confirmed by the study of Zeitun and Gary (2007), which examined the relationship of ownership concentration and firm performance both in terms of accounting measures and market measures using a sample of public listed companies on the Jordan stock exchange. They found a significant positive relationship between ownership concentration and accounting performance measures. Abor and Biekpe (2007) investigated the effects of corporate governance and ownership structure on the performance of SMEs in Ghana. They found that CEO duality, board size, board composition, inside ownership, and family ownership have significant positive impacts on profitability. Despite these efforts, the various performance implications of ownership concentration and structure are yet to be explored with a particular focus on emerging economies.

2.12 Summary

This chapter reviewed the literature relating to corporate governance systems, practices and their impact on the performance from different theoretical perspectives. The literature shows that the corporate governance practices and their efficiency are largely determined by the corporate governance system of a country. Thus, the practices that are appropriate and efficient in one country are not necessarily appropriate for

another country. Although there are arguments for the convergence of corporate governance models due to globalization of business activities, the research evidences suggest that full convergence is far from reality due to contextual differences of countries. The literature further shows that the ownership structure of a company plays an important role in determining the level of compliance to corporate governance best practices. However, the studies of corporate governance and firm performance report mixed results.

The research findings identified that the level of compliance to corporate governance practices and their impact on corporate performance is determined by the corporate governance system and other contextual conditions of a country. As the study is designed to examine the efficiency of corporate governance practices adopted by Sri Lankan listed companies, it is important to explore the corporate governance environment in Sri Lanka. Thus, the historical development of corporate governance; legislative and institutional framework of corporate governance; and, corporate governance codes development process in the Sri Lankan context are explored in the next chapter.

Chapter 3 : The Corporate Governance Environment in Sri Lanka: Regulatory Framework and Recent Developments

3.1 Introduction

Corporate governance regulation in Sri Lanka comprises: the *Companies Act No.07 of 2007*; SEC regulations; CSE listing rules and other regulations; *Sri Lankan Accounting and Auditing Standards Act No.15 of 1995*; industry specific Acts; and, other by-laws. Voluntary and mandatory corporate governance codes of ICASL and SEC also promote corporate governance best practice. This chapter outlines the evolution of corporate governance in Sri Lanka and discusses various provisions, specifically: an overview of the local historical development of corporate governance; the legislative and institutional frameworks with reference to quoted public companies; legislative requirements aimed at ensuring improved corporate governance; and, the provisions of corporate governance codes of Sri Lanka. A chapter summary is provided in the final section.

3.2 Historical Developments of Corporate Governance

The history of corporate governance in Sri Lanka dates back to its period under the British regime nearly 150 years before it gained independence in 1948. From the 18th Century onwards, imperialism penetrated Sri Lanka causing two effects on its feudal society. "The first was the transformation of kingship into the colonial state and, the second was the emergence of plantation based mercantile economy" (Alawattage and Wickramasinghe, 2004, p.8). With the establishment of plantation companies, the funds and expertise were channelled from Britain. British investors contributed capital through the London stock market and the Colombo Brokers Association (CBA).

In the early days, companies were governed by English law, which was introduced to Sri Lanka in the Civil Law Ordinance of No. 5 of 1852. The Joint Stock Companies Ordinance No. 4 of 1861 was the first company law enacted specially for Sri Lanka. With the development of the plantation sector, "cultivators experimented with new ways of getting money for their business. They started local companies and distributed shares to the general public" (The Registrar of Companies, 2011). As a

result, steps were taken to amend the 1861 Ordinance and to introduce the Companies Ordinance No 51 of 1938. In introducing this new ordinance, the necessity of a separate institution to fulfil the needs of the companies and to effect the provisions had been identified. Accordingly the Department of the Registrar of Companies was established in 1938 (The Registrar of Companies, 2011). The CBA commenced the trading of shares in limited liability companies in 1896. Since the CBA was the authority for granting public quotations, its rules and regulations were applicable to all public companies wishing to have their shares quoted in the official list. The by-laws of the association were derived from those of the London Stock Exchange and were more advanced than those of the local Companies Ordinance of 1938 (Perera, 1975). The fundamental corporate governance framework of the country during the colonial era was provided by the provisions of the Companies Ordinance and the listing rules and guidelines stipulated by the CBA.

Attention to corporate governance in Sri Lanka again re-emerged after 1977, following the shift from socialist to market-oriented policies with the introduction of open economic policies. The passing of the constitution in 1978 opened the doors to a free economy and many economic changes, by shifting controls from the government to the private business sector. Large scale development projects were funded by the World Bank, International Monetary Fund and Asian Development Bank. A ‘Free Trade Zone Program’ opened the door for foreign direct investments and multinational corporations. Imports and foreign exchange restrictions were relaxed and commercial businesses grew. New export industries such as the garment industry were encouraged (The Central Bank of Sri Lanka, 1998). The entrance of a large number of new companies into the market created a highly competitive environment, making Sri Lanka attractive to foreign investors.

With foreign investment came international methods of evaluating business, for example, a firms’ financial performance became as a key factor informing investor decision-making. Local investment managers and other related professionals also became attentive to the financial performance of companies. As a result, many new institutional and regulatory developments were introduced, for example the establishment of the Securities and Exchange Commission in 1987, and the introduction

of the Companies Act No.17 of 1982. These reforms led the standardization of corporate governance functions in the country.

The Companies Act No. 17 of 1982 (*The Act*) incorporated many provisions that encouraged good governance practices, providing the legal framework which governs the commercial affairs of the country. *The Act* regulates: disclosures in companies' annual financial statements; conduct of board proceedings; conduct of shareholders' meetings; directors' responsibilities and reporting; audit procedures; provisions relating to the winding up of companies; and, processes connected to borrowings by companies.

The Securities and Exchange Commission (SEC) of Sri Lanka was established in 1987 through the *Securities and Exchange Commission Act No.36*. From its inception the Commission was active in developing rules and regulations for financial reporting and the capital market in Sri Lanka. This act was amended in 1991 empowering the SEC to regulate, for example: unit trusts, stock brokers; registration of market intermediaries; and, to grant licenses to stock exchanges. The next amendment to this Act in 2003 added to its powers the regulation of: underwriters; margin providers; credit rating agencies; investment managers; and, clearing houses, and widened the investigation powers of the SEC. The 2009 amendment further allowed for the regulation of derivatives, and gave the SEC authority to issue directives to listed companies. With these amendments, the infrastructure is in place for the SEC to play a dynamic role in Sri Lanka's capital market development, and improve governance practices in the country (SEC, 2011).

The CBA ran The Colombo Share Market for almost a century until 1985. The CSE, which took over operations of stock market from the CBA, was established in 1985 to formalize the share trading in Sri Lanka. The CSE is a company limited by guarantee, established under the Companies Act No. 17 of 1982. The CSE has power to regulate the share trading to establish an orderly and fair market, through its listing rules. These include accounting and reporting regulations. All companies listed on the CSE must abide by these rules (Colombo Stock Exchange, 2011).

Despite establishing legal and institutional frameworks for corporate governance as described above, in the late 1980's and early 1990's Sri Lanka witnessed many

corporate failures, especially finance companies. Many reasons were attributed for these failures, but nobody took responsibility. The disappointed investing public lost their faith in the regulatory frameworks and made accusations of their being inefficient financial reporting and auditing procedures in Sri Lanka (Sobhan and Werner, 2003). This crisis paved the way to address Sri Lanka's weak enforcement of its financial reporting and auditing standards. As a result The Institute of Chartered Accountants of Sri Lanka (ICASL) established a task force to study all aspects regarding enforcement of the Sri Lanka Accounting Standards (SLAS). The task force recommended the setting up of an 'Accounting Standard Monitoring Unit', which resulted in the enactment of the *Sri Lanka Accounting and Auditing Standard Act No. 15* of 1995. This Act empowered the ICASL to adopt Sri Lanka Accounting Standards (SLAS) and Sri Lanka Auditing Standards (SLAuS). Furthermore, this 1995 Act made provisions to establish the Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB) to carry out an independent monitoring function. All specified business enterprises (SBE) (refer Appendix 1 for the list of SBE) under this 1995 Act are required to prepare their financial statements in compliance with SLAS, and be audited as per the SLAuS. It also requires every SBE to submit a copy of its annual reports to the SLAASMB for examination. This process compels SBE's to comply with mandated accounting and auditing standards, which in turn is expected to generate higher quality financial statements.

The establishment of an Urgent Issues Task Force (UITF) by the ICASL in 1993 was another milestone in attempting to improve financial reporting quality, and thereby strengthen companies' governance structures. The UITF has a mandate to give interpretations and clarifications of accounting and auditing standards in their application in different practical situations. This committee is regarded by the business and financial sector as a prominent institutional mechanism in understanding and applying SLAS and SLAuS (Sobhan and Werner, 2003).

Sri Lanka developed formal corporate governance codes of best practice after the 1990s, through its regulatory regimes. The first real effort in codifying corporate governance practices began in 1996 when the Council of the ICASL formed a committee to make recommendations on financial aspects of corporate governance (Sobhan and Werner, 2003). After this initiative, several other regulatory organizations,

professional institutions and ICASL developed new codes, in keeping with the development of corporate governance codes globally, especially in the UK. The Schedule of Corporate Governance Codes developed by various institutions is given in the Table 3.1 below.

Table 3.1 The Development of Corporate Governance Codes in Sri Lanka.

Year	Code	Institutions	Implementation
Dec. 1997	The Code of Best Practice: Matters relating to Financial Aspects of Corporate Governance	ICASL	Voluntary
July 2001	Handbook on Corporate Governance: Principles and Guidelines to Best Practice in Sri Lanka	Institute of Chartered Secretaries and Administrators in Sri Lanka	Voluntary
May 2002	Code of Best Practice on Audit Committees	ICASL	Voluntary
June 2002	Code of Corporate Governance for Banks and Other Financial Institutions	The Central Bank of Sri Lanka	Voluntary
March 2003	Code of Best Practice on Corporate Governance	ICASL	Voluntary
May 2004	Guidelines for Listed Companies in respect of Audit and Audit Committees	SEC & ICASL	Voluntary
March 2007	Standard on Corporate Governance for Listed Companies (Section 6 of Listing Rules)	CSE with the support of SEC and ICASL	Mandatory
June 2008	Code of Best Practice on Corporate Governance	ICASL & SEC	Voluntary
July 2008	Guidelines for Appointment of Auditors of Listed Companies	SEC	Voluntary
April 2008	The Banking Act Direction No.1: Corporate Governance	The Central Bank of Sri Lanka	Mandatory
Oct. 2008	Finance Company Direction No.3: Corporate Governance	The Central Bank of Sri Lanka	Mandatory

The introduction of a revised *Companies Act No. 7 of 2007* incorporating further corporate governance provisions, and the formulation of several mandatory corporate governance codes in 2008, are important to Sri Lanka's corporate governance regulatory framework. This modernised 2007 *Act* was influenced by its Canadian and New Zealand counterparts and is in line with global legislation, dealing comprehensively with matters relating to: transparency; accountability; directors' duties; and, the protecting interests of all stakeholders (Senaratne, 2011).

The ICASL, jointly with the SEC, developed a voluntary corporate governance code of best practices in 2008 for listed companies, to be used in combination with the requirements incorporated in the CSE Listing Rules (which themselves were made

mandatory in April 2008). The Central Bank of Sri Lanka also issued two mandatory codes – *the Banking Act Direction No. 1 of 2008* and the *Finance Companies Direction No. 3 of 2008 on Corporate Governance,* applicable to licensed commercial banks and finance companies respectively. Both codes took effect from 1st January 2009. These codes set out fundamental governance principles and rules in relation to commercial banks and finance companies.

Throughout the period described above, as now, the media in Sri Lanka were active in highlighting business and commercial issues. Potential investors and stakeholders make use media sources to gain knowledge about what is happening in the business world. Companies are aware of the importance of positive publicity and maintaining the media's goodwill. Engaging good corporate governance practices assists companies' relations with the media, and ensures the general public as well as shareholders and other various groups of stakeholders are informed that they are meeting their corporate governance responsibilities.

3.3 Legislative and Institutional Framework of Corporate Governance

Section 3.2 describes the historical development of the Sri Lankan corporate governance legislative and institutional framework. Relevant identified legislation and regulations pertaining to Sri Lankan corporate financial reporting are the: *Companies Act No. 07 of 2007*; *Accounting and Auditing Standards Act No. 15 of 1995*; *Securities and Exchange Commission Act of 1987*; and, the Continuing Listing Requirements of the CSE. In addition, there are sector specific acts, for example, *The Banking Act No. 30 of 1988, The Finance Companies Act No. 78 of 1988* and *The Insurance Act No. 43 of 2000*.

Institutions that regulate and monitor corporate governance requirements of Sri Lankan companies include the: Registrar of Companies; SEC, CSE, Central Bank of Sri Lanka, ICASAL; and, the SLAASMB. This legislation and these institutions are discussed in subsequent sections.

3.3.1 Securities and Exchange Commission (SEC)

As introduced in Section 3.2, the SEC of Sri Lanka was established through the *Securities and Exchange Commission of Sri Lanka Act, No.36 of 1987,* to regulate the securities market in Sri Lanka for the protection of investors and the maintenance of order and fairness in securities trading in the market, and to operate a compensation fund to protect investors (Securities and Exchange Commission of Sri Lanka, 2010). The *Securities and Exchange Commission Act* sets out the legal framework for the formalisation and regulation of the securities market of Sri Lanka.

The SEC is active in developing a securities market in Sri Lanka by playing a role in corporate governance, financial reporting and regulatory issues of listed companies. The SEC established the 'Central Depository System', formed the *Mergers and Takeovers Code of 1985*, and implements laws relating to insider trading, etc. (Sobhan and Werner, 2003). The SEC issues guidelines and rules pertaining to accounting, auditing, and listing requirements for both routine and non-routine disclosures of public listed companies. For example, the SEC issued the 'Guidelines for Appointment of Auditors of Listed Companies' in 2008 with a view to strengthening the effectiveness of audits while enhancing the accuracy, transparency, constancy and reliability of financial reporting. Further, through a Memorandum of Understanding with the SLAASMB, the SEC has agreed to refer cases of non-compliance with SLASs to the SLAASMB (Senaratne, 2011).

The activities of the SEC have been criticized on a number of issues, such as: conflicts of interest; slow responses to public complaints and concerns; unfair and arbitrary rulings; not being up-to-date with international and regional developments; not maintaining a sufficient level of independence and objectivity; and, alleged biased decisions made by some SEC members (Sobhan and Werner, 2003). These issues erode public confidence in the capital market of Sri Lanka. As the SEC plays an important role in enforcing standards of corporate governance, any deficiency in discharging its duties has a negative impact on corporate governance system of the country.

3.3.2 Colombo Stock Exchange (CSE)

The CSE, a company limited by guarantee, was established in 1985 under the *Companies Act No. 17 of 1982* of Sri Lanka and is licensed by the SEC to operate as a

stock exchange in Sri Lanka. The CSE evolved over a long period of time. Share trading in Sri Lanka commenced in 1896 when Sri Lanka was under the British rule, to raise finances for tea plantation companies. At its inception, stock trading was done by the CBA. The CSE took over the operations of the Colombo Stock Market in 1985 from the CBA and commenced public trading using the open outcry system, facilitating secondary trading of equity and debt instruments. The listing of companies is on a tiered basis, with the 'Main Board' used for larger companies, and the 'Second Board' used for small and medium companies. It also operates an 'Over-the-Counter Market' (OTC) for unlisted companies (Bandaranaike, 2002).

The developments of the CSE are closely associated with economic policy changes of the country. The free market economic policies of 1978 and the emergence of the private sector as the dominant force of the economy caused a restructuring of the stock market. The post 1977 economic reforms such as: an opening up of the banking sector to both foreign owned and local private banks; a reduction in taxes on transfers of property and share purchases; the privatisation of state-owned enterprises; the promotion of foreign investments; and, granting of permission for foreign funds to operate in the stock market all contributed to the revitalisation of the CSE after 1977. In 1997, trading activities on the CSE were automated. The CSE had 241 companies representing 20 business sectors as at 31st December 2010. The market capitalisation of the CSE stood at Rs. 2,210.45 billion as at 31st December 2010 (Colombo Stock Exchange, 2011).

The policies of the CSE are formulated by its board comprising nine directors, of whom five directors are elected by its members at the AGM, while four members are appointed by Finance Minister on the recommendation of the SEC. The board of the CSE has established five sub-committees to deal with administrative and regulatory aspects of the stock exchange. These committees are the: Rules and Bylaws Committee; Finance Research and Development Committee; Arbitration and Disciplinary Committee; Audit Committee; and, Client-Broker Dispute Resolution Committee.

The CSE is a self-regulatory organization which has several rules and regulations that govern listed companies and member firms. These rules and regulations are: listing rules; member regulations; rules of clearing, settlement and depository

activities; and, conditions of trading rules. The listing rules, especially continuing listing requirements, ensure listed companies comply with best corporate governance and corporate disclosure practices. In order to strengthen the corporate governance best practices of listed companies, the CSE incorporated standards of corporate governance best practices into its listing rules in 2008. Compliance to listing rules is continuously monitored by the CSE. A separate division headed by a senior manager is entrusted with the responsibility of market monitoring and surveillance. This includes monitoring the continuing listing requirements of listed companies, compliance by member firms of the member regulations, and on-line market monitoring and surveillance (Bandaranaike, 2002). These developments have contributed to improving corporate governance of listed companies as well as the overall corporate governance systems in the country.

3.3.3 Accounting Profession in Sri Lanka

The first national professional accounting body, the Institute of Chartered Accountants of Sri Lanka (ICASL) was established in 1959 under the *Parliament Act No. 23 of 1959*. The ICASL replaced the Accounting Board which functioned as the only authoritative accounting body in Sri Lanka during the period of 1941 to 1959 (Wijewardena and Yapa, 1998). This paved the way to produce chartered accountants locally. The ICASL has significant influence over national policy formulation in areas of accounting, auditing, and tax. It is the sole authority in setting accounting and auditing standards in Sri Lanka. The *Accounting and Auditing Standards Act No. 15 of 1995* ratifies the ICASL to issue and manage accounting and auditing standards which are applicable to listed companies and other SBEs identified in *The Act*. In addition to these activities, the ICASL has been active in setting corporate governance codes since 1996. The first effort in setting the codes of corporate governance in a structured manner began in 1996 by a committee appointed by the council of ICASL. This initiated the evolution of corporate governance principles and practices in Sri Lanka. Thereafter, many initiatives followed, as described in Section 3.5 of this chapter.

Other Sri Lankan professional accountancy bodies include the Association of Accounting Technicians of Sri Lanka (AATSL), the Society of Certified Management Accountants of Sri Lanka (CMASL), the Institute of Internal Auditors (IIA), and the Institute of Public Finance and Development Accountancy (IPFDA). British professional accountancy bodies also have a strong and growing presence in Sri Lanka.

The two most significant bodies are the Chartered Institute of Management Accountants (CIMA) and the Association of Certified Chartered Accountants (ACCA). CIMA supports management accounting practices of firms and improving the management accounting profession worldwide. ACCA's scope includes financial reporting, auditing and management accounting and sustainability reporting (Wijewardena and Yapa, 1998).

3.3.4 The Registrar of Companies

The Registrar of Companies (ROC), established in 1938, is the administrative authority of all companies established or registered in Sri Lanka. It is responsible for the implementation of the *Companies Act,* and is empowered to incorporate public and private limited liability companies and to register foreign and off-shore companies. The ROC is also required to act in vigilance in respect of effective functioning of all companies in accordance with the Companies Act. The registrar functions as an ex-officio member of the board of the SEC, in order to reduce overlaps in regulatory monitoring exercised by the ROC and the SEC in the areas of investors' protection and accounting disclosures.

3.3.5 Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB)

SLAASMB was established through the *Accounting and Auditing Standards Act No. 15 of 1995* to monitor and enforce compliance with accounting and auditing standards by SBEs. It comprises thirteen members representing regulatory bodies and professional accounting institutions. These members include: three ex-officio members being the Registrar of Companies, the Commissioner General of Inland Revenue, and the Director General of the SEC; and, ten members appointed by the minister including: an officer of the Central Bank as the nominee of the Governor; three members of ICASL; a member of the Sri Lanka Division of the CIMA; two company directors; a senior lawyer; a senior banker; and a nominee of the University Grants Commission. The *Act (1995)* requires every SBE to forward a copy of its annual report to the Monitoring Board for examination of its compliance with accounting standards. The *Act (1995)* has an indemnity provision for the Monitoring Board and its officials with regard to their actions against non-compliance. The Monitoring Board functions support compliance with best corporate governance practices by companies.

3.4 Legislative Requirements

3.4.1 The Companies Act

The *Companies Act No.07 of 2007* came into operation on 3rd May 2007 by replacing the *Companies Act of No. 17 of 1982,* which had been based on the 1948 Companies Act in U.K which was written 60 years previously and behind contemporary times in terms of global developments in international trade and commerce. The new Act has provisions on accounting, auditing, disclosures and other corporate governance requirements which encourage good governance practices. Extensive sections of the *Companies Act* deal with: maintenance of proper accounting records; disclosures in the annual financial statements; conduct of board proceedings; conduct of shareholders meetings; particulars regarding proxies; directors' reports; responsibilities of directors; appointment of auditors; and auditors' functions. The *Companies Act* also sets out the provisions relating to the winding up of companies, and certain procedures connected to borrowings by companies. These provisions serve as a useful framework for proper governance of companies.

The requirements to keep accounting records and financial statements are specified in the sections 148 to 151 of *The Companies Act*. As per section 148, "a company has to keep proper accounting records and these records should enable (a) the financial position of a company to be determined with reasonable accuracy, (b) directors to prepare financial statements in terms of the Act, and (c) the company's financial statements to be properly audited". A Company has to prepare financial statements within 6 months of the Balance Sheet date (section 150) in a way that gives "a true and fair view" of the state of the affairs of company as at the balance sheet date, and the profit or loss of the company for the accounting period ending on the balance sheet date (section 151). The financial statements have to be certified by the person responsible for their preparation that they are in compliance with the requirements of *The Companies Act*, and signed by two directors on behalf of the board. It further requires financial statements should comply with the requirements of any other laws which apply to a company's financial statements. Thus, preparation of financial statements includes compliance with the *Sri Lanka Accounting and Auditing Standards Act No. 15 of 1995*. Furthermore, the financial statements of Public Listed Companies should also comply with the *Securities and Exchange Commission Act*. These provisions enhance the reliability of financial statements.

The Companies Act has specific provisions dealing with the annual report of companies in addition to the provisions on the maintenance of accounting records and the preparation of financial statements. Sections 166 to 169 of *The Companies Act* regulate company annual reports with respect to their: preparation; contents; distribution to shareholders; and, implications of failing to distribute it to shareholders. A company has to prepare an annual report on its affairs within six months of balance sheet date, and distribute a copy to shareholders 15 days before its AGM, which should be held each calendar year not later than six months after the balance sheet date of the company, and no later than fifteen months after the previous AGM (section 133). Further, a company has to deliver an annual return to the Registrar of Companies each year as specified in section 131. The annual report should contain both financial as well as non-financial information as detailed in section 168. These requirements not only facilitate but also encourage shareholders to monitor company affairs, ensuring the board is vigilant in complying with best corporate governance practices.

The *Companies Act* requires that the financial statements of companies be audited annually. It also deals with the appointment and remuneration of auditors, and disqualifications for appointments as auditors. The auditors should report to the shareholders on the accounts examined by them (section 163). The first auditor of a company is appointed by the board (section 159) and thereafter the auditor is appointed at the AGM (section 154). The fees and expenses of an auditor are approved at the AGM (section 155). The Directors' Report is to be attached to every annual report, which should contain information as to: the state of a company's affairs; the amount that directors recommend to be paid as dividends to shareholders; directors' direct and indirect interests in contracts and the nature of such interests; and, whether there were any directors' declarations of interests in meetings of the directors. Furthermore, directors' duties to: act in good faith and in the interests of company; comply with the requirements of *The Act*; delegate powers and maintain supervision and monitoring of these delegated responsibilities, are also specified with greater detail in *The Companies Act*, ensuring proper functioning of the boards of companies.

3.4.2 Accounting and Auditing Standards Act

The *Sri Lanka Accounting and Auditing Standards Act No. 15 of 1995* formalizes the accounting and auditing standards-setting process empowering the

ICASL, and provides the framework for their implementation and monitoring in SBEs operating in Sri Lanka. *The Act* also provides for the formation and functioning of the Accounting Standards Committee (ASC) and Auditing Standards Committee (AuSC) that make recommendations to the Council of ICASL for the adoption of accounting and auditing standards respectively under the authority vested in it by section 2 of this *Act*. The objective of the ASC is to keep SLAS harmonised with International Financial Reporting Standards (IFRS). Hence, it makes recommendations on the adoption of IFRS as SLAS after making necessary modifications to suit the regulatory conditions of Sri Lanka. Such modifications are kept minimal to ensure that SLAS comply with IFRS in material aspects.

This *Act* has also established the SLAASMB to monitor and enforce compliance with SLAS and SLAuS. Such monitoring is essential to ensure that the accounting standards are rigorously interpreted and applied by companies. *The Act* also requires that professionally qualified members, who shall be members of the ICASL with a certificate to practise, should audit the accounts of SBE in terms of SLAuS.

3.5 Sri Lankan Corporate Governance Codes

The codification of corporate governance practices began in 1996 when the ICASL formed a committee to make recommendations on matters relating to financial aspects of corporate governance, with the support of the: CSE; SEC; Ceylon Chamber of Commerce; and, the Institute of Directors of Sri Lanka. One recommendation was to have a 'Code of Best Practices' applicable to all listed companies. Accordingly, the ICASL published the first report on the *Code of Best Practice on Matters Relating to Financial Aspects of Corporate Governance* in 1997. After this initial effort, several other regulatory organizations, professional institutions and ICASL developed subsequent codes in keeping with the development of corporate governance codes globally, especially in the UK. A 'Schedule of Corporate Governance Codes' that were developed by various institutions, is given in Table 3.1.

Both these voluntary and mandatory codes aim to improve the governance practices of companies listed on the CSE. All have been devised based on the codes developed in the UK. These include: the *Cadbury Committee Report* (1992); the

Hampel Report, 1998 (known as T*he Combined Code* 1998); the *Turnbull Committee Recommendations* (1999); the *Smith Committee Report on Audit Committees* (2003) and the *Combined Code* (2003) (Watawala, 2006). In developing these codes representations have also been received from institutions such as The Ceylon Chamber of Commerce, CIMA Sri Lanka Division, The Institute of Chartered Secretaries, Sri Lanka Bankers Association and Sri Lanka Institute of Directors. Some deal with specific areas of corporate governance. The 'ICASL Code of Best Practice on Audit Committees 2002' provides detailed guidance on the scope and functions of the audit committee of listed companies. Similar examples are the 'Code of Corporate Governance for Banks and Other Financial Institutions 2002' issued by the Central Bank, and 'Guidelines for Listed Companies in respect of Audit and Audit Committees 2004' issued by the SEC. However, the Codes of Best practices of Corporate Governance developed by ICASL in 2003 and 2008 capture the broader aspects of corporate governance with special emphasis on the roles and responsibilities of boards of directors (Senaratne, 2011).

All the *Codes of Best Practices* of the ICASL have been developed based on the Anglo-Saxon model of corporate governance, due to the close association of Sri Lankan accounting and company law requirements with the British system. As Sri Lanka was under the colonial rule of Britain from 1796 to 1948, many Sri Lankan firms' roots go back to pre-independence under the British rule. As a result Sri Lankan companies are influenced by British systems. Most of the corporate governance codes are largely focussed on the responsibilities, structure and organization of a board of directors with the aim of improving its monitoring role. These codes have been developed on the assumption that ownership and control of corporate entities are separated. As a result, the board of directors is considered crucial in establishing the relationship between the shareholders and the management of these entities. Hence, the central issue addressed in these codes is the protection of shareholders' rights. Thus, they advocate improvement of accountability, integrity, efficiency, and transparency as the core corporate governance perspectives.

Corporate governance best practices for Sri Lankan companies evolved from the introduction of the first voluntary code of best practice in 1997, to the mandatory codes on corporate governance in 2008. The first mandatory code; *Standard on Corporate Governance for Listed Companies* is incorporated into the Listing Rules of the CSE,

effective from 1st April 2007. However, the companies are given some flexibly in compliance with these governance rules in the first year of operation. These rules were mandatory from 1st April 2008 for all listed companies. The Central Bank of Sri Lanka has also issued mandatory codes – *the Banking Act Direction No. 1 of 2008 and Finance Companies Direction No. 3 of 2008 on Corporate Governance* for the licensed commercial banks and the finance companies respectively. These codes are in operation with effect from 1st January 2009. The developments in best practices have been influenced to a greater extent by the continuous international dialogue on the need to strengthen the corporate governance practices to achieve economic prosperity. The main features of these codes are discussed in the subsequent sections.

3.5.1 Code of Best Practice of ICASL - 1997

The first code of best practice of corporate governance was issued in 1997 by ICASL to deal with financial aspects of corporate governance of Sri Lankan listed companies. This was developed after studying such reports published in other countries. However, the rules embedded in the code were primarily based on *The Cadbury Report* (Watawala 2006). The scope of this code is extended to embrace all listed companies, unit trusts, fund management companies, finance companies, banks, and insurance companies for voluntary compliance. It deals corporate governance aspects under two main headings: 'Board of Directors' and 'Audit'.

This code is developed on the Anglo-Saxon model and therefore roles and responsibilities of the board of directors have been given more emphasis. Section one (The Board of Directors) of *The Code* provides the governance practices to improve the effectiveness of the board. This section deals with the separation of the roles of chairman and CEO; independent non- executive directors and their advisory role; directors' training and professional advice; structure and responsibilities of the audit committee; structure and appointment of the remuneration committee; and, board responsibility for the preparation of financial statements. Section two (Audit) of *The Code* deals with governance practices relevant to external audit. These include procedures to ensure the effectiveness of external audits; responsibilities of the audit committee; procedures for the rotation of auditors; and, the disclosure of audit fees in the financial statements.

This *Code* was not comprehensive and only addressed the financial aspects of corporate governance. Thus, this *Code* was replaced by the ICASL Code of Best Practice on Corporate Governance in March 2003.

3.5.2 The Code of Best Practice of ICASL - 2003

Owing to the changes in the global corporate governance landscape, the ICASL appointed a committee in 2001 to revise the existing 1997 code to strengthen corporate governance practices in Sri Lanka. This code is largely based on *The Combined Code, 1998* (Hample Report) of the UK. Accordingly the ICASL Code (2003) covers corporate governance requirements under two main sections: 'The Company'; and, 'Institutional Shareholders' (refer Appendix 2). In addition, *The Code* includes schedules of: terms of reference for nomination committees; boards' self-assessment checklist; terms of reference for remuneration committees; provisions for the design of performance-related remuneration; matters for consideration when making a going concern assumption; and, a summary of governance disclosures to be included in the Annual Report. Compliance with this code is voluntary, but the companies are required to incorporate a corporate governance report in their annual report, setting out the manner and extent to which the company has complied with the established principles and practices of this code. In the event of non-compliance, companies are required to disclose the reasons for such non-compliance.

Section One of the Code deals with the governance principles pertaining to the board of directors, namely: board procedures and meetings; the role of the chairman; separation of the roles of chairman and CEO; the financial acumen of directors; board balance of executive and non-executive directors including independent non-executive directors; supply of information to directors; appointments to the board through a nomination committee; re-election of directors; appraisal of the performance of the board and the CEO. It also encompasses requirements pertaining to directors' remuneration, namely: responsibilities of the remuneration committee; the amount and composition of remuneration for both executive and non-executive directors; and, disclosures on remuneration. Requirements for relations with shareholders include: the constructive use of the AGM; and, disclosure of major transactions to shareholders. Aspects of audit and accountability addressed include: financial reporting; internal control; responsibilities of the audit committee and auditors; and, inclusion of a

‘Corporate Governance Report’ in the Annual Report). Section Two (Institutional Shareholders) of the Code deals with governance principles relevant to institutional and other investors of a company, and, especially with institutional shareholders’ role in voting and evaluating governance disclosures, and individual shareholders’ investing or divesting decisions and voting.

The ICASL Code also recommends making several governance disclosures in the annual report of a company. They are: Corporate Governance Report; Directors’ Report; Management Report; Directors’ Statement setting out their responsibility for the preparation of financial statements; auditors’ statement on their reporting responsibilities; directors’ statement on the going concern of the business; directors’ statement on internal controls; statement on remuneration policy; details of remuneration; and, membership of audit and remuneration committees. Further, on appointment of a new director, it is required to disclose a brief resume of the director, nature of his/her expertise in relevant functional areas, and other companies in which he/she holds directorships and membership of board committees (Schedule F).

Although the ICASL Code (2003) was developed taking into account global corporate governance initiatives, it has not kept pace with the corporate governance developments that had taken place, particularly after the collapse of Enron in 2001. The key deficiencies of the ICASL Code can be observed in relation to the provisions for: non-executive directors; nomination committees; performance evaluation of boards; directors’ training; shareholders; and, corporate governance disclosures.

The following limitations can be identified in relation to non-executive directors: the role of non-executive directors is not specifically mentioned; the criteria to decide their independence are not given; there is no requirement for non-executive directors to meet regularly as a group without the presence of executive directors; and, no specific provisions relevant to the appointment and tenure of non-executive directors. The role of the nomination committee is limited to making recommendations to the board on new appointments. Its role in succession-planning for board appointments and senior management positions of the company is not specifically identified. Further, there is no requirement that the membership of the nomination committee should consist of a

majority of non-executive directors. Performance evaluation of a board is limited to its self-assessment and appraisal of its CEO. It does not cover the performance evaluation of board committees and other directors. The directors' training requirement is limited to induction training. No reference has been made to provide training continuously to update directors' skills and knowledge (Senaratne and Gunaratne, 2008).

The section on shareholders does neither address the need to maintain a dialogue with institutional shareholders, nor require that the board committee chairmen should participate at the AGM to answer shareholders' questions. The following limitations can be seen in relation to the prescribed corporate governance disclosures: the specific disclosures to be made in the Corporate Governance Report are not identified; the application of the system of internal controls and risk management processes are not covered in the Statement on Internal Controls; and the provision of board committee reports and the distinction of audit and non-audit fees are not specifically addressed (Senaratne, 2011).

3.5.3 The Code of Best Practice of ICASL – 2008

The ICASL Code (2003) was subsequently replaced by the 'Code of Best Practice on Corporate Governance (2008)', which was prepared by ICASL jointly with the SEC in consultation with CSE. The joint committee developed the Code (2008) for voluntarily compliance by listed companies in conjunction with the mandatory rules on corporate governance that have been incorporated into the CSE Listing Rules. The mandatory rules prescribe a minimal level of corporate governance without imposing an excessive regulatory burden. The voluntary code was developed after studying various corporate governance reports published in other countries. The foreword to the Code (2008) recognizes that the committee has reviewed the Combined Code (2003) of U.K., the NYSE Code of U.S., Code on Corporate Governance of Singapore, Principles for Good Governance and Best Practices Recommendations of the Australia Stock Exchange, the Malaysia Code on Corporate Governance and the Corporate Governance Report of the Securities and Exchange Board of India.

The code provides its recommendations under the two broad headings: The Company; and, Shareholders (refer Appendix 2). It covers principles on corporate governance in relation to directors, directors' remuneration, relations with shareholders,

accountability and audit, institutional investors, and other investors. All these aspects are covered in greater detail when compared to ICASL Code 2003. Thus, this code addresses most of the limitations of previous governance codes (The ICASL Code 2003). The special recommendations made in this code in addressing the limitations of previous codes include: the proportion or minimum number of non-executive directors in a board: the criteria and definitions to determine the independence of non-executive directors; requirement for the non-executive directors to meet regularly as a group without the presence of executive directors; provisions in case of CEO duality; provisions regarding the evaluation of performance of board committees; disclosure of information in respect of directors; terms of reference specifying purpose, duties and responsibilities of audit committees and provisions regarding the conduct of regular and structured dialog with shareholders. Another special feature of this code is that it requires companies to adopt a 'Code of Business Conduct and Ethics' for directors and senior management.

3.5.4 Standards on Corporate Governance in Listing Rules – 2007

The ICASL and the SEC in consultation with the CSE undertook a joint initiative in 2006 to formulate standards on corporate governance for mandatory compliance of the listed companies in the CSE. These standards have been developed after taking into consideration the latest developments in the corporate governance standards of UK and USA and they cover: the minimum number of non-executive and independent directors to be present on the board; the criteria for determining 'independence' of non-executive directors; disclosures required to be made by listed companies in respect of its directors; and, the minimum requirements to be met by listed companies in respect of the audit committee and the remuneration committee (refer Appendix 3). In respect of both audit committee and remuneration committee, the composition, functions and the relevant disclosures in the annual report have been specified.

These standards have been included in section 6 of CSE Listing Rules of 2007 and in section 7.10 of the amended Listing Rules of 2009. The compliance with these rules is mandatory for listed companies from 1st April 2008. Failure to comply with listing rules would result in incurring penalties. In the event of violation or non-compliance with the Listing Rules, securities of the entity will be transferred to the

"Default Board" which may publicly reprimand such entity. Continued violation of the Listing Rules will result in suspension of trading of securities of such an entity for any period of time, or delisting of the entity from the exchange.

These rules provide only the minimum standards to be met by a listed company, and the *ICASL Code (2008)* is voluntarily, to be applied in conjunction with mandatory rules. The introduction of mandatory corporate governance listing requirements is a significant move towards the improvement of governance practices of Sri Lankan listed companies.

3.5.5 Code of Best Practice on Audit Committees of ICASL, 2002

This Code sets out the role, objectives and the composition of audit committees of Sri Lankan listed companies. It states that the role of an audit committee is to oversee the financial reporting system of the company, with a view to safeguarding the interests of its shareholders and the other stakeholders. In order to fulfil this role, the audit committee should assist its board of directors to ensure: a sound financial reporting system is in place that is well managed; that the board carry out business risk management; manage internal controls; comply with laws and company policies; and, assess the independence of external auditors and monitor their functions. The composition of the audit committee set out in the Code is same as that of the Cadbury Report of the U.K. It also covers audit committee meetings and communications with internal and external auditors of the company. The most important aspect of this Code is that it sets out the methodology that an audit committee should follow to achieve these objectives. The methodology covers the committee's relationship with the finance director, the internal auditor and the external auditor. This section provides the companies with a checklist to evaluate the effectiveness of audit committees.

3.5.6 SEC Guidelines for Audit and Audit Committees of Listed Companies, 2004

The objectives SEC Guidelines (2004) are to strengthen the effectiveness of the existing audit process and to promote adoption of corporate governance practices relating to audit and audit committees which are comparable with global standards. Further it intends to enhance the accuracy, transparency, and reliability of financial statements of listed companies in order to instil investor confidence. These Guidelines are focused on two areas: guidelines for external auditors to be followed in auditing the

listed companies; and, guidelines for audit committees of listed companies. The former deals with amongst other things: the qualifications, appointment, powers and remuneration of auditors; audit partner rotation; conflicts of interest; independence of auditors; disclosure requirements; financial reporting; and, restricted and permissible non-audit services which can be practiced by the external auditor. The latter deals with the: composition; objectives; powers; and, duties of audit committees.

3.6 Corporate Governance Studies in Sri Lanka

As in many other emerging markets in Asia, the ownership of Sri Lankan companies is highly concentrated, with a presence of controlling shareholders in most enterprises. The study by Samarakoon (1999) examines the ownership structure of 222 companies listed in the CSE during the financial year 1997/98 and finds that the ownership of these companies is highly concentrated with the presence of controlling shareholders in most companies. These findings suggest that large shareholders have a significant influence on corporate governance structure and practices of Sri Lankan companies. However, the focus of this study is limited to the distribution of corporate ownership among various types of shareholders such as: large vs. small; resident vs. non-resident; and institutional vs. individual.

The study by Senaratne and Gunaratne (2007), which examines the ownership structure and corporate governance of the sample of 60 listed companies in Sri Lanka, reveals that the ownership of Sri Lankan companies is concentrated and characterized by certain features, such as: holding controlling ownership by another corporate entity; wide prevalence of family ownership as the ultimate owners; existence of pyramid ownership structure; and, the absence of active institutional shareholders. Therefore, corporate control in Sri Lanka often lies in the hands of a few individuals, families or corporate groups who hold the majority of ownership. The results of the study suggest that the concentrated ownership structure could have a significant influence on the governance structure of the companies. The existing governance structure of Sri Lankan companies, characterized by their domination by controlling shareholders, shows some similarity to the insider systems of corporate governance model. However, whether this type of ownership structure affects firm performance has not been examined in any prior research on Sri Lanka.

SEC of Sri Lanka carried out a survey in 2005 to identify the composition and structure of audit committees of the listed companies in Sri Lanka. It reveals that out of 132 listed companies responded the questionnaire, 50 companies did not have audit committees. The survey also revealed much variation in the composition, functions and operational modalities with regard to audit committees. It further revealed that the regulatory framework does not provide definitive guidance on audit committees. However, this survey is limited to the functions of the audit committees.

A survey conducted by Cabraal (2003) using annual reports disclosures relating to corporate governance of 50 public listed companies in Sri Lanka, report that there is no sufficient evidence to suggest that many of corporate governance practices that corporate entities said publicly that they were following, were in fact being practiced professionally. The study reports that certain listed companies in Sri Lanka were merely setting out certain sections of the corporate governance best practices or the practices recommended in Cadbury Report without a clear link to the rest of their reports. Further, there were no guidelines in the annual report as to how these are actually followed in the company. As findings of the study suggest non-availability of an established mechanism to verify the actual level of compliance by companies with the best practices aggravates this problem.

The Sri Lankan studies reviewed in this section provide empirical evidence regarding ownership structures and the corporate governance practices of Sri Lankan listed companies to a certain extent. However, the studies reviewed do not provide sufficient evidence regarding corporate ownership structure and corporate governance practices and their influence on corporate performance. There is no study which examines the stakeholders' perception on corporate governance in Si Lanka. Hence, there are many unresolved areas in the efficiency of corporate governance practices and governance structure of Sri Lankan companies. Although the suitability of corporate governance practices which are adopted from developed countries (refer Section 3.5) to Sri Lankan companies is questionable, no prior research has examined the validity of these practices to Sri Lankan companies. Therefore, an objective of this study is to fill this gap by examining the compliance of corporate governance best practices by Sri Lankan companies with ownership implications, and to analyse this issue from stakeholders' points of view.

3.6 Summary

This chapter describes the regulatory and institutional frameworks of corporate governance requirements, and the provisions of corporate governance codes applicable to Sri Lankan listed companies. Further, this Chapter outlines the historical development of corporate governance practices in Sri Lanka. Players in the legal and institutional frameworks in Sri Lanka include the SEC, the CSE, the Registrar of Companies, the SLAASMB, and professional Accounting institutions especially ICASL. It is concluded that there is a sound regulatory framework for corporate governance in Sri Lanka. The legislative corporate governance requirements for listed companies in Sri Lanka are primarily provided by the Companies Act, SEC rules, CSE listing rules and Sri Lanka Accounting and Auditing Standards Act. In addition to regulatory requirements, the corporate governance codes play a vital role in promoting corporate governance best practices in Sri Lankan companies. Several attempts have been made by the ICASL and the SEC to introduce the codes of corporate governance best practices to Sri Lankan companies, which have been strongly influenced by economic policy changes, especially the adoption of open economic policies after 1977. Further, the governance systems of Sri Lankan companies show characteristics of the Anglo-Saxon system as they are strongly influenced by British systems. In addition, the international developments of corporate governance have strongly influenced the current changes in governance practices of Sri Lankan companies. This chapter further indicated that there is a vacuum of research in Sri Lanka in the areas of corporate governance suggesting needs for further studies.

On this background, the study design three empirical investigations to explore the efficiency of corporate governance practices of Sri Lankan listed companies. These empirical investigations are: a survey of compliance to corporate governance best practices; a survey of stakeholders' perception of corporate governance practices and the impact of ownership concentration on firm performance in Sri Lankan public listed companies. The design and the methods of these investigations are discussed in the next chapter.

Chapter 4 : Research Design and Methods

4.1 Introduction

This research is conducted in order to determine whether Sri Lankan listed companies comply with best corporate governance practices, and whether concentrated ownership of these companies influence levels of firm compliance and firm performance. Stakeholders' perceptions of corporate governance in Sri Lanka are also examined. In order to achieve these research objectives, a survey was conducted amongst the CEOs and the Chairmen of Sri Lankan listed companies. Further, the views of seven stakeholder groups were also obtained through a survey questionnaire structure in Likert-scale format. The impact of ownership concentration on firm performance is assessed using secondary data obtained from a database and the annual reports of sample companies. Data gathered from these devices are then analysed for interpretations with the support of literature.

This chapter presents the research design and the methods used in examining the objectives of the study. It describes the sample, the methods of data collection, measurement of variables and the methods of data analysis used in relation to three empirical investigations carried out in the study. First, the research problem, research questions and research design are discussed in order to provide a framework of the study. Secondly, methods applied in examining: 1) the nature and level of compliance with corporate governance best practices by Sri Lankan companies; and, 2) impacts of ownership concentration on the levels of compliance and firm performance are described. Thirdly, methods applied in examining stakeholders' perceptions of corporate governance practices are described. Fourthly, methods applied in testing the impact of ownership concentration on firm performance are explained. The last section presents a summary of this chapter.

4.2 The Research Problem

The relative efficiency of alternate corporate governance models and systems, especially relative efficiencies between the market model and the relationship-based model of corporate governance, is an important issue for many corporate governance researches (John and Senbet, 1998). This issue attracts more attention when emerging markets seek to implement suitable corporate governance systems for their economies.

The governance reforms of most emerging markets are influenced by practices of the market informed Anglo-Saxon model, owing to their historical and economic links with developed economies. But, it is argued that this conventional corporate governance system has limited effectiveness in emerging markets, as most of these economies have governance systems with weak institutional frameworks, poor property rights and their public companies are subjected to concentrated ownership (Claessens and Fan, 2002). Further, it is argued that the theory derived from the studies of developed countries is limited in applicability to emerging markets (Farinha, 2003).

Although efficiency of corporate governance mechanisms, especially internal governance mechanisms of public listed companies in emerging markets is an important aspect to be examined in governance reforms, there is a dearth of research on firm level corporate governance practices in these markets. Furthermore, ownership structure and the relationship between ownership structure and firm performance are issues that are yet to be explored in Asian markets (Claessens and Fan, 2002). While there are many studies which examine the impact of ownership concentration on firm performance most of these studies are conducted in developed economies (Demsetz and Lehn, 1985, Shleifer and Vishny, 1986, Morck et al., 1988, Thomsen et al., 2006). The contextual settings of developed countries differ vastly from those of emerging markets and therefore the results of these studies cannot be generalized without paying thorough attention to contextual idiosyncrasies (Claessens et al., 2000).Therefore, there is a vacuum in academic literature on corporate governance, especially firm level governance practices of emerging markets.

Sri Lanka has been using corporate governance practices originating in developed countries, especially British practices, despite the fact that there have been vast differences in their business and governance environments compared to Sri Lanka. Sri Lankan corporate governance characteristics such as ownership concentration and bank-led finance resemble the characteristics of the relationship-based model (Senaratne and Gunaratne, 2008). Further, corporate governance practices are largely recommended through the voluntary codes. As a result, managers of public listed companies in Sri Lanka have considerable discretion in deciding the types and the extent of corporate governance practices implemented in their companies. However, there is a lack of research studies which examine firm level corporate governance

practices and their performance implications in Sri Lanka. Therefore, this study examines the nature and level of compliance to best practices, and the implications of ownership concentration on the level of compliance and firm performance of Sri Lankan listed companies. Further, it examines the stakeholders' perceptions of the corporate governance system of Sri Lanka in order to assess the efficiency of corporate governance practices of Sri Lankan listed companies. Six specific questions are addressed in the study.

(1) What is the historical development and current status of corporate governance practices in Sri Lanka?
(2) What is the nature and level of compliance maintained by Sri Lankan companies in respect of corporate governance best practices?
(3) Does the concentration of ownership with family, foreign or controlling owners have an impact on the level of compliance with corporate governance practices in Sri Lankan companies?
(4) Do facilitating corporate governance best practices enable improvement in corporate performance in Sri Lankan companies?
(5) Do current corporate governance practices in Sri Lanka meet the stakeholders' expectations?
(6) Does ownership concentration influence firm performance of Sri Lankan companies?

4.3 Objectives of the Study

The surveys and investigations of the study realise eight objectives. Specifically, this study of Sri Lankan listed companies:

(1) assesses the corporate governance environment and the process of corporate governance codes' development in Sri Lanka;
(2) examines the nature of compliance with corporate governance best practices recommended by prevailing codes;
(3) assesses the level of compliance with corporate governance best practices through the development of a Sri Lankan corporate governance index;
(4) examines the impacts of ownership on levels of compliance with corporate governance best practices;

(5) examines the impact of compliance with corporate governance best practices on firm performance, proposing that a higher level of compliance will enhance firm performance;
(6) assesses stakeholders' perceptions of corporate governance practices, strategies and identified issues;
(7) examines the impacts of ownership concentration on firms' performances; and,
(8) recognizes features of current corporate governance practices, and makes recommendations.

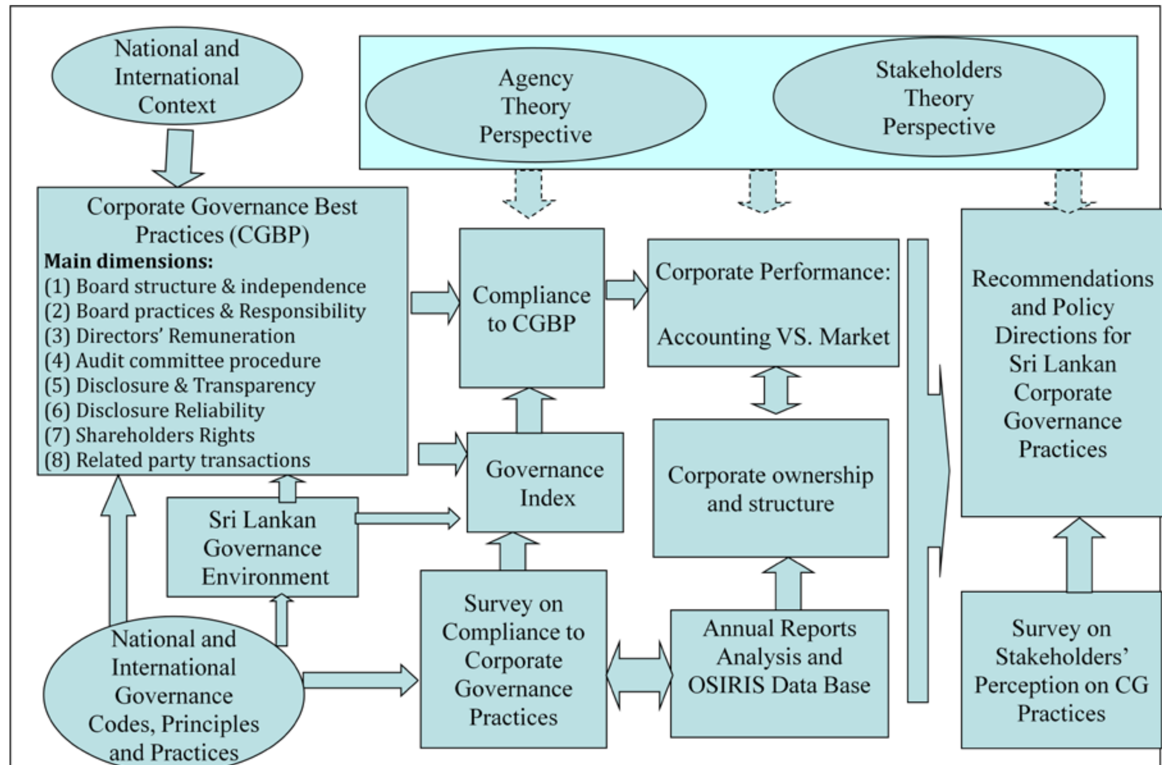
4.4 Research Design and Approach

The research is oriented in a positivist theoretical perspective, and the descriptive method of research is used in the empirical investigations of the study. The aim of descriptive research is to provide information regarding the current status and the characteristics of a particular phenomenon. This is usually exploratory in nature and attempts to determine the status of a particular area (Heppner et al., 2008). The descriptive research aims to verify formulated hypotheses that refer to the present situation. This method can be used either with qualitative or quantitative data or both, giving flexibility in selecting the devices for data-gathering. It is useful in describing the occurrence and characteristics of the phenomena that are being studied, and therefore is useful for developing remedial actions. Thus, the findings are useful in managerial decision-making (Creswell, 1994).

The use of a particular method for a research project depends on the scope, purpose and target population of the study, as well as the resources available to the researcher (Gill and Johnson, 2002). As depicted in the 'Overall Research Framework' given below, three empirical investigations have been carried out in this study: first a survey of compliance with corporate governance best practices; second a survey of stakeholders' perceptions of corporate governance practices in Sri Lanka; and, third the impact of ownership concentration on firm performance in Sri Lankan public listed companies. Furthermore, an analysis of legal and institutional frameworks of corporate governance practices in Sri Lanka and their evolution is also undertaken to assess the present status of corporate governance requirements. The aim of this research is to assess the efficiency of compliance with corporate governance requirements in Sri Lankan listed companies based on these empirical investigations. Furthermore, the

descriptive method is advantageous to these investigations due to its flexibility in accommodating both quantitative and qualitative analysis of data gathered through questionnaire surveys and other secondary sources.

Figure 4-1Overall Research Framework



1. Survey of compliance with corporate governance best practices

Despite the presence of legal and institutional frameworks, regulatory requirements, and voluntary corporate governance codes governing public listed companies in Sri Lanka, how these instruments are applied may deviate from their intended application. In the first empirical investigation of this study, compliance with best corporate governance practices by Sri Lankan quoted public companies, and the impacts of ownership concentration on levels of compliance and firm performance are examined.

2. Survey of stakeholders' perceptions of corporate governance

The second investigation examines the perceptions of stakeholder groups regarding the present status and issues of corporate governance in Sri Lanka.

3. The impact of ownership concentration on firm performance

The third investigation examines the impact of ownership concentration and ownership structure on a firm's performance on the premise of agency theory assumptions.

In this context, this chapter deals with the methods used to examine the objectives of study except objectives one and eight. Objective one is addressed in chapter three whereas objective eight is addressed in chapter eight. This chapter describes methods of three empirical investigations relating to objectives two to seven. The Section 4.5 describes the method applied in achieving objectives two, three, four and five while Section 4.6 describes the method applied in achieving objective six. The method applied in testing the impact of ownership concentration on performance is explained in the Section 4.7.

4.5 Survey of Compliance to Corporate Governance Practices

This investigation examines the nature and level of compliance with best corporate governance practices by Sri Lankan quoted public companies. In the first part of the study, the nature of compliance with best corporate governance practices is evaluated based on questionnaire survey data using percentage and frequency analysis. In the second section, the level of compliance with corporate governance practices is assessed based on the corporate governance index developed on questionnaire survey data. It is expected that concentration of ownership by family, foreign or controlling owners could have significant impacts on compliance with best corporate governance practices. In the third section, impacts of such ownership concentration on compliance with corporate governance are examined based on the corporate governance index scores. Finally, the impacts of compliance with corporate governance practices on firms' performance are examined. Through these examinations, the study aims to address the research questions (2), (3) and (4) mentioned above.

4.5.1 Selection of the Sample

As the study considers the level of compliance with corporate governance best practices by Sri Lankan companies from a capital market perspective, it is based on public listed companies in Sri Lanka. All companies listed on the CSE during the 2009/10 financial year are considered in the initial sample of the study. After excluding delisted companies as per the listing schedule of CSE, 230 actively trading companies are selected for the final sample, representing all industry sectors of the CSE (refer Table 4.1).

4.5.2 Data, Data Collection, and Measurement of Variables

The study uses both primary data and secondary data. Collection of primary data in relation to compliance with corporate governance practices is done through a questionnaire survey. Secondary data in relation to accounting performance, market price data and additional governance information were obtained from three sources: the annual reports of the relevant companies, Bureau Van Dijk's OSIRIS database (OSIRIS), and the CSE database. Items of interest to this study were: relevant balance sheets and income statements; ownership structures; shareholdings of main shareholders; market prices of shares; and, the size and composition of the board of directors. Datarelating to accounting performance measures were obtained from the OSIRIS database. Information on ownership structure, major shareholdings and the size and composition of the board was extracted from annual reports. Share price information of sample firms was obtained from the CSE database. Data collection methods and the corporate governance variables are discussed in detail in the subsequent sections.

4.5.2.1 Questionnaire Survey

Copies of questionnaire (refer Appendix 4) were mailed to either the Chairman or the CEO of the sample companies from December 2009 to January 2010. An address data base was developed using information available on the CSE website and/or the websites of sample companies. The questionnaire was mailed to a sample of companies classified under each industry sector, as shown in Table 4.1. The mailed questionnaire method is considered appropriate in this study as it covers a large sample of companies cost effectively. The response rate of a mailed questionnaire survey can be improved by sending follow-up letters, incorporating self-addressed postage paid return envelops and keeping the questionnaire brief and clear (Sekaran, 2000). Accordingly, the questionnaires were sent with a covering letter addressed to the personal name of recipients, and a postage-paid reply envelope. Further, a copy of the 'Participant's Information Sheet' (refer Appendix 5) which is a requirement of the ethics committee is also attached to convey the confidentiality of individual data of the study to the participants. Recipients were asked to return the completed questionnaire by mail.

Table 4.1 Sample Companies across each Industry Sector

	Industry Sector	Questionnaire Mailed
1	Bank Finance and Insurance	33
2	Beverage Food and Tobacco	18
3	Chemicals and Pharmaceuticals	9
4	Construction and Engineering	3
5	Diversified Holdings	11
6	Footwear and Textiles	3
7	Health Care	6
8	Hotels and Travels	32
9	Information Technology	1
10	Investment Trust	9
11	Land And Property	20
12	Manufacturing	31
13	Motors	6
14	Oil Palms	5
15	Plantation	18
16	Power and Energy	3
17	Services	6
18	Stores and Supplies	5
18	Telecommunication	2
20	Trading	9
		230

Several approaches were adopted to improve the response rate. The questionnaire was allowed to be completed by either the Chairman or CEO or a suitable representative on their behalf. Reminder letters were posted approximately three weeks after the first post of questionnaires (refer Appendix 6). The same questionnaire was developed into digitally answerable format and sent through e-mails where email addresses of intended recipients were available. Based on the researcher's personal contacts, assistance from two senior partners of leading audit firms in Sri Lanka (Ernest & Young and KPMG) were obtained to distribute questionnaires personally among CEOs using their capacity as the audit partners of these companies.

4.5.2.2 Design of the Questionnaire

The development of the questionnaire has undergone two stages. In the first stage main attributes of corporate governance practices have been identified by referring to national and international codes, regulations and guidelines. These attributes are

classified under eight dimensions of corporate governance, which form the basis of the questionnaire. In the second stage specific questions were developed by reference to prior research studies covering these attributes (Nam and Nam, 2004, Balasubramanian et al., 2007, Jongsureyapart, 2006, Ho, 2005, Institute of Corporate Directors, 2007, KPMG in Sri Lanka, 2007). Additional questions were also developed suitable to the context of the study. All questions are shown in closed form and the majority of questions expect a 'yes' or 'no' response, as it surveys compliance with corporate governance best practices. Furthermore, this form of questioning is used as a strategy to improve the response rate.

The questionnaire consists of thirty-five questions, classified in four parts, namely; general information; board structure and practices; stakeholders' rights; and, related party transactions (refer Appendix 4). In Part I, questions 1 to 3 focus on information about the participants such as: official positions; gender; and, educational background. Questions 4 to 7 focus on company characteristics such as: overall ownership; family ownership; foreign ownership; influential groups in policy making; and, the status of labor unions of the company. These questions are adopted from Nam and Nam (2004).

Part II is focused on the composition and procedures of the boards and subcommittees including: board composition; board functions and meetings; committees' procedures; and, appointment, remuneration and performance evaluation of directors. Questions 8 and 9 seek data about the composition of the board such as: proper balance of the board; minority and institutional shareholders' representation; and, both independent and non-executive directors on the board. These questions are developed by reference to the Sri Lankan corporate governance requirements. Questions 10 and 11 relate to boards' procedures, while questions twelve to fourteen relate to boards' meetings. The governing bylaws, non-executive directors' appointment, their participation, recording of minutes, and frequency, duration and participation in board meetings are examined by these questions which are adopted from Nam and Nam (2004), Ho (2005) and Balasubramanian et al. (2007).

Questions 15 to 19 investigate board sub committees recommended by governance codes. Frequency of meetings is examined by questions 15 and 16, in order

to access the active contribution of sub-committees in boards' decision making processes. Question 17 has ten sub-items relating to audit committees, such as: structure, operational mechanism, independence, and members' qualifications. Question 17 is adopted from Nam and Nam (2004). A similar approach is adopted in questions 18 and 19, which are designed to investigate the efficiency of remuneration and nomination committees respectively. Operating mechanisms, committee independence and the conduct of meetings are considered in these questions.

A high proportion of family ownership and holding of managerial positions by family members are common characteristics of most Asian companies (Khan, 2003, Nam and Nam, 2004, Bhasa, 2004). Those observations are applicable to Sri Lankan companies (Senaratne and Gunaratne, 2007). Hence, board appointments and remuneration procedures of directors are given prominence in designing the questions. Question 20 seeks information relevant to fair and transparent appointments to the board, whereas question 21 interrogates remuneration policies, approvals, and the relationship between remuneration and performance. In the context of high concentration of family ownership, the appointments and remuneration can be decided based on personal relationships instead of experience or skills of appointees. The establishment of a proper performance evaluation system of the directors is desirable to enhance overall board performance and to secure shareholders' rights. Questions 22 and 23 are designed to investigate these attributes. Directors' code of conduct and ethics is an important attribute, especially in a relationship-based governance model. Question 24 gathers information on this aspect, including training opportunities available to directors.

Part III (questions 25 to 31) investigates the stakeholders' rights and disclosures, addressing whether the shareholders' rights are protected with respect to: voting; participation in shareholder meetings; conduct of shareholder meetings; and, disclosure of adequate information including related party transactions. Question 26 gathers information on the external audit function as an auditor's role is vital for the protection of the shareholders' rights. Question 27 inspects the extent of obtaining non-audit services from external auditors as it may affect auditors' independence. Questions 30 and 31 investigate the availability of information on the company's web-site and in its

annual report. These questions are adopted from Nam and Nam (2004), Ho (2005) and Balasubramanian et al. (2007).

Related party transactions have been identified as an important aspect which requires adequate controls and disclosures by many governance codes, guidelines and accounting standards. Conflict between controlling and non-controlling shareholders is an important issue of corporate governance, as controlling shareholders are able to tunnel company assets for their own benefit, either through direct participation or by influencing management (Johnson et al., 2000). As the ownership of Sri Lankan companies is highly concentrated some with family ownership, the related party transactions require special attention. Part IV of the questionnaire focuses on related party transactions which include all transactions between the firm and its related parties such as board members, principle owners, management and their immediate family members and affiliated companies. Questions 32 to 35, which are adopted from Balasubramanian et al. (2007), gather data on the nature and size and required approval levels of related party transactions.

To improve the understandability, practical applicability and overall validity of the questionnaire several procedures were adopted. The draft questionnaire was sent to two senior members of the Corporate Governance Code Development Committee of the ICASL, asking them to assess the practical application of the questionnaire. To improve the overall validity, the questionnaire was reviewed by a company director. This procedure confirmed that the questions are suitable for the intended audience. Some minor modifications to incorporate their comments were made before administering the questionnaire.

4.5.2.3 Corporate Governance Variables

The corporate governance variables used in this analysis indicate practices prescribed in national and international corporate governance codes. The Sri Lanka Corporate Governance Code (2008), Listing Rules (2009) of CSE (refer Section 3.5), OECD principals (2004) (refer Section 2.3) and the prior research studies (Nam and Nam, 2004, Balasubramanian et al., 2010, Balasubramanian et al., 2007, Ho, 2005, Gompers et al., 2003) are used in the process of identifying appropriate governance variables for the study. These practices are categorised under eight dimensions, namely:

board structure & independence; board procedure and effectiveness; audit committee procedure; directors' remuneration; disclosure and transparency; disclosure reliability; shareholders rights; and, related party transactions. These variables were investigated using information obtained through the questionnaire.

Table 4.2 Variables Investigated in the Questionnaire

	Dimensions	Variables investigated	Question Reference
		General Information:	
		1. Information about respondents	1 - 3
		2. Company characteristics	
		2.1 Nature and family ownership	4
		2.2 Foreign ownership	5
		2.3 Policy influence	7
1	Board structure and independence	3. Board structure composition	
		3.1 Composition and size	8,9
		3.2 CEO Duality	& 11
2	Board Procedure and Effectiveness	4. Board Procedure	
		4.1 Board Practices	10
		4.2 Board Meetings	12 - 14
		4.3 Board Committees	15 & 16
		5. Appointment of directors	
		5.1 Nomination Committee	19
		5.2 Appointment procedure	20
		6. Performance evaluation of the Directors	
		6.1 Executive Directors	22
		6.2 Non-executive directors	23
		7. Code of conduct and assistance	24
3	Directors' Remuneration	8. Remuneration Committee	18
		9. Remuneration procedure	21
4	Audit Committee Procedure	10.Audit committee	
		10.1 Structure	17
		10.2 Meetings	16
		10.3 Practices	17
5	Disclosure and Transparency	11. Information Disclosure	
		11.1 Disclosure in the Web	30
		11.2 Disclosure in the Annual Reports	31
6	Disclosure Reliability	12. Auditor’s independence and work	26 & 27
7	Shareholders Rights	13. Applicable rules and meetings	25,28,29
8	Related party transactions	14. Nature and magnitude	32 & 33
		15. Required approval level	34 & 35

The main variables recognised in each dimension are sub-classified into fifteen categories, including information of respondents and responding companies as indicated in Table 4.2. These variables are designed to analyse the nature of compliance to important aspects of corporate governance such as: board composition; board practices, board meetings; practices of board sub-committees; appointments to the board; performance evaluation of the board and directors; remuneration procedure; audit committee procedure; disclosure and disclosure reliability; shareholders' rights and related party transactions.

Dimensions one to four address a board's structure and practices. The board should be structured in such a way that good governance practices are facilitated and not hindered. Corporate governance is centred on the board of directors, since they are responsible for setting objectives and formulating strategies to attain those objectives. Further, they are responsible for overall supervision, and carrying out proper monitoring to ensure the rights of shareholders. The associated principles of these dimensions include: a structure supporting distinct roles of supervision and executive management; composition of the board; the experience of directors; a formal and transparent procedure for the election of directors; re-election requirements; compensation of executives and directors; performance evaluation; and, audit committees.

Dimensions five to eight focus on the shareholders' rights and disclosures. The board is responsible for protecting shareholders' rights and ensuring equitable treatment to all shareholders, including regulatory safeguards, transparency and accountability. The key functions of the board include effective supervision and monitoring, ensuring accountability to shareholders and other stakeholders. The effective governance system provides the mechanism which ensures the supervisory and monitoring roles of the management. These dimensions include attributes such as rules for safeguarding shareholders' rights; frequency of having shareholders meetings; existence of a written governance policy; participation of both executive and non-executive directors in shareholders meetings; regular and rigorous review of board performance, internal control and audit, related party transactions, and, risk assessment reports. These variables are employed in evaluating the nature of compliance to corporate governance best practices by sample companies.

4.5.2.4 Construction of Corporate Governance Index and Level of Compliance

Another aspect considered in objective three is the assessment of the relative levels of compliance with corporate governance best practices amongst sample companies. The relative levels of compliance are assessed based on the scores of Corporate Governance Index (CGI) constructed in the study (refer Appendix 7). The CGI scores of sample companies indicate the extent to which they have complied with the best practice. The subsequent sections describe the basis of preparation, variables and scores of the CGI.

(a) Basis of Preparation of the Corporate Governance Index:

The CGI is constructed consisting eight sub-indices representing corporate governance dimensions (refer Table 4.2) examined in the study. The variables of CGI are recognised through the synthesis of the SLCGC (2008), the OECD principles and relevant international guidelines (refer Section 2.6). The recommended practices of SLCGC (2008) and the requirements of *Companies Act No.07 of 2007* are provided the basis for the construction of the CGI. Further, some of the practices are identified through the perusal of OECD principles since the study aims to investigate compliance to best practices in a broader perspective.

The CGI is constructed referring to the previous research studies (Balasubramanian et al., 2010, Ho, 2005, Susilowati et al., 2005), and the corporate governance indices of rating agencies (refer Section 2.7). In previous studies, various proxy variables are used to assess the level of compliance to corporate governance practices and these variables are recognised under different aspects of corporate governance such as: board structure; board procedure; audit committee practices; directors compensation; shareholders' rights; and, related party transactions (Balasubramanian et al., 2007); board structure; stewardship; strategic leadership; capital structure and market relations; and, social responsibilities (Ho, 2005); and presence of independent directors; availability of audit committees; conduct of the external audit; and the percentage of shares held by outsiders and insiders (Susilowati et al., 2005). Furthermore, the professional associations and rating agencies have also developed governance indices covering a broad range of areas using variables as discussed in Section 2.7 (refer Table 2.1 and Table 2.2). This structure and variables of these indices have provided useful guidance in developing the CGI. However, the CGI

of the study differs to other indices in terms of its focus, coverage and purpose. The CGI consists of 90 variables classified under eight dimensions. The main aspects covered in this index are discussed in the following section.

(b) Variables of Corporate Governance Index and Sub-indices:

There is much focus on the conduct of board members and effective discharge of their responsibilities as the roles and responsibilities of a board reinforce corporate governance structure of a company securing better performance. Hence, the board functions are given high priority in constructing the CGI. The practices required for effective corporate governance are identified under eight dimensions namely: board structure & independence; board effectiveness; directors' remuneration procedure; audit committee procedure; disclosure substance; disclosure reliability; shareholders rights; and, related party transactions.

The CGI is based on the data gathered through the questionnaire. Sub-indices represent each of the dimensions, and are constructed to evaluate a level of compliance with each of these aspects. The number of variables of each sub-index consists of: board structure & independence (07); board effectiveness (25); directors' remuneration (08); audit committee procedure (10); disclosure and transparency (15); disclosure reliability (05); shareholders rights (12); and, related party transactions (08). Accordingly, the maximum score of the CGI is equal to 90, which is the addition of maximum marks of its eight sub-indices (refer Appendix 7). A brief description of each sub-index is given below.

(I)Board structure & independence: This sub-index deals with the ability of a board to work independently to secure the rights of shareholders and to enhance the overall performance of the firm. The variables considered in sub-index include the following: board composition; the balance of executive and non-executive directors; the independence of non-executive directors; CEO duality; the selection of non-executive directors; and the active participation of non-executive directors in board decisions. Overall, the ability of non-executive and independent directors to work independently on the board and their contribution towards the board's decision making process are considered.

(II) Board Effectiveness: This sub-index covers how directors discharge their roles effectively to enhance the overall performance of the firm, and to protect the interests of shareholders and other stakeholders. The variables included in this sub-index cover the following: role of the board; board practices; board meetings; board committees; the appointment and re-election of directors; the appointment procedure; the existence and role of a nomination committee; performance evaluation of the board and succession planning; provision of information to the directors and their professional development; conduct of board and board committee meetings; outside commitments of directors; financial acumen of board members; and, the presence of a code of conduct and ethics for directors.

(III) Audit Committee Procedure: This sub-index covers the governance principles relevant to the conduct of the audit committee of a company, which acts independently from the executives, to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal controls. Hence, the variables included in this section cover the composition, authority, and responsibilities of the audit committee, and its relationship with the auditors (both internal and external) of the company.

(IV) Directors' Remuneration: This sub-index deals with governance principles relating to the determination of directors' remuneration, as it is important to align directors' interests with the overall performance of the firm. The variables included in this sub-index cover: the procedure of deciding directors' remuneration (the appointment of a remuneration committee and its composition); the remuneration policy of the company; performance related elements of remuneration; and, whether there is shareholders' approval for long-term incentive schemes.

(V) Disclosure Substance: This sub-index addresses disclosures relevant to enhance the rights of shareholders and other stakeholders. The disclosure of annual and quarterly financial statements, directors' reports and directors' share transactions on the firm's web page are considered as key variables. In addition, the variables included in this sub-index cover the following: related party transactions; internal controls and risk management policies; the audit committee's report; directors' remuneration; reports of remuneration and nomination committees; resumes of directors; and, audit and non-audit fees. These disclosures are necessary for the shareholders to assess the

effectiveness of the governance structures of companies, in order to supervise and control the conduct of those who control the company.

(VI) Disclosure Reliability (Auditor independence): This sub-index covers the governance principles required to secure disclosure reliability. The variables included in this section cover the independence of external auditor. The magnitude of non-audit services provided by the auditor, rotation of audit partners, reviews of the auditor's work by an audit committee, and the full board review of the audit report are considered as the key variables.

(VII) Shareholders Rights: This sub-index covers the governance principles relevant to the shareholders' rights in respect of voting, conduct of AGM, pre-emptive rights and related party transactions. The variables included cover the following: exercise of voting rights of shareholders; voting by mail and proxy rights; constructive use of AGM; availability of board committee chairmen to answer shareholders' questions at the AGM; availability of written guidelines for directors' share dealings and other related party transactions; and, representation of minority shareholder in the board.

(VIII) Related party transactions: As the ownership of Sri Lankan companies is highly concentrated with family owners, the related party transactions require special attention. It is possible to use related party transactions as a means of tunnelling firm resources. The governance principles relevant to execution and disclosure of related party transactions have been identified in this sub-index as the main variables. The variables included in this sub-index cover the following: nature and magnitude of the related party transactions; required approval level for the execution; and, review of these transactions by the board.

4.5.3 Methods of Data Analysis

The analytical techniques used in the study are both quantitative and qualitative in nature. The quantitative data analysis methods include percentage analysis, frequency analysis and other statistical analysis. The level of compliance to corporate governance best practices is determined based on the scores of the CGI and the sub-indices. A statistical analysis is carried out using the SPSS Statistical Package in order to examine the impact of levels of compliance on firm's performance and the impact of ownership

on the level of compliance. These analytical techniques are discussed in detail in the subsequent sections.

4.5.3.1 Nature of Compliance to Corporate Governance best practices

The analysis of compliance to corporate governance best practices is carried out using the governance variables as identified in Table 4.2. Non-responding bias and other data limitations are assessed prior to the analysis of compliance. The significance of non-response bias is estimated by comparing the means of selected financial and governance variables of responded and non-responded firms using an independent sample t-test. Other data limitations such as incomplete respondent knowledge and self-responding bias are discussed descriptively.

The First section of the analysis consists of general information regarding respondents and responding companies. A percentage analysis is carried out to examine the nature of family ownership and foreign shareholdings of Sri Lankan companies. The survey results are analysed using percentage and frequency analysis. This is contextualised referring to relevant literature, specifically Sri Lankan governance codes to identify the strength and weakness of each aspect considered. Variables used are: board structure composition; board procedure; appointment of board members; performance evaluation of the directors; code of conduct; audit and remuneration committee procedure; information disclosure; disclosure reliability; shareholders' rights; and, related party transactions.

4.5.3.2 Level of Compliance to Corporate governance Best Practices

The scores of CGI and sub-indices are analysed based on a number of methods in assessing the level of compliance of corporate governance best practices by sample companies. Scores of the CGI and the sub-indices are analysed using descriptive statistics and frequency distribution to find out overall behaviours of compliance level of corporate governance practices. As the compliance to governance practices can significantly be different across the nature of ownership of the firm (Nam and Nam, 2004, Balasubramanian et al., 2010) three pairs of sub samples are indentified based on the family ownership, foreign ownership and the presence of controlling shareholders of the companies. The subgroups family based (FB) and non family based (NFB) are identified using the family ownership whereas subgroups of substantially foreign owned

(SFO) and less foreign owned (LFO) are identified using foreign ownership of sample companies. The controlling ownership is one of the main features of Asian companies. Thus, the third sub groups are identified based on the presence of controlling owners. These three categories of subgroups are recognized based on the information collected through the questionnaire and the analysis of annual reports of the sample companies.

The analysis is carried out across subgroups of each ownership dimension in order to identify whether there are significant differences across sub groups regarding compliance to corporate governance best practices. The comparative analysis of sub-index scores across subgroups is carried out to identify the level of compliance with each aspect of corporate governance. Furthermore, comparative analysis of individual variables in each sub-index across subgroups is carried out to find out whether there are significant differences between subgroups regarding compliance to each variable. It also illustrates the behaviour of the scores of individual variables of the CGI and how these variables contribute to its total score. Hence, this analysis provides a comprehensive view of the level of compliance to governance practices of sample companies. The comparison of corporate governance scores of three subgroups are carried out in order to reveal the distinguishing features and associated issues of corporate governance practices of these ownership dimensions.

4.5.3.3 Impact of Ownership on Level of Corporate Governance Compliance

The compliance to governance practices can be different across the firms due the influence of the controlling owners of the firms. The controlling ownership can be concentrated on family members or foreign owners. Similarly, without any particular group ownership, it can be concentrated on few individuals. In order to achieve the forth objective of the study, a t-test is carried out to find out whether there is a significant difference between corresponding sub-samples identified based on three dimensions of ownership. The mean differences of the scores of CGI and the sub-indices of sub samples are compared using independent samples t-test.

4.5.3.4 Impact of Corporate Governance Compliance on Firm Performance

The main aspect considered in objective five of the study is the impact of compliance to corporate governance best practices on firm performance. This examination is carried out on the proposition that a higher level of compliance will

enhance the firm performance based on the theoretical assertion and the findings of research studies as discussed in Sections 2.3 and 2.7 respectively. The total corporate governance scores and sub indices scores of sample companies are used as the indicator of the level of corporate governance.

The performance variables include return on assets (ROA) (net profit before tax to total assets) and return on equity (ROE) (net profit after tax to total equity) as the accounting performance measures. The market performance variables include the proxy Tobin Q (TQ) (market value of a firm's equity plus the book value of its debt to the book value of total assets) and market-to-book-value ratio (MBR) (market value of a firm's equity to its book value). These variables are measured using share price information and data extracted from the annual reports of sample companies.

ROA and ROE is measured in terms of five-year average during the period 2006 -2010. The market value of equity is measured in terms of monthly average market price of shares for the year 2010. The book value of debts and total assets are extracted from the financial statements for the year 2009/10 of sample companies. The variables are measured using average values to minimise the effect of temporary fluctuations. In order to examine the performance implications of corporate governance compliance, the sample is divided into two sub samples, as high compliance and low compliance companies based on the overall index score. Based on mean value of the index score, a company that has scored 61 or more for the overall index is defined as a high compliance company, whereas an overall index score less than 61 is considered as a low compliance company.

The study is based on the assumption that the level of compliance to corporate governance best practices would improve overall management efficiency and thereby overall performance of the company. The accounting performance measures are employed to capture the impact of overall performance of the company. Further, the level of corporate governance would have a positive impact on investors' expectation on market share prices. Therefore, market performance measures are applied to capture the impact of compliance to corporate governance practices on market value of the shares. Based on the assumed casual relationship, the following hypotheses are developed to

examine the relationship between corporate governance variables and the performance variables.

1 Companies with higher corporate governance index scores are likely to have a higher accounting performance.
2 Companies with higher corporate governance index scores are likely to have a higher market performance.

In order to test these hypotheses, a comparative analysis of corporate governance index score of sub-samples is carried out based on correlation analysis and the t-test for independent samples.

4.6 Survey on stakeholders' perception on corporate governance

This investigation examines the perception of various stakeholder groups in relation to present status, strategies, practices and main issues of corporate governance and as to how these issues should be addressed in Sri Lankan context using the questionnaire survey method. Over the last decades, the interest on corporate governance increased greatly, making it a central topic of various discussions among stakeholder groups of the companies. The large-scale corporate collapses and increased regulatory requirements have created stronger stakeholder interest in corporate governance practices across the globe. Thus corporate governance has become a subject of considerable public interest. As a result, the empirical examination of stakeholder perception on corporate governance has become the subject matter of various studies focused on corporate governance issues (Mckinsey, 2002, Nam and Nam, 2004, Ho, 2005). However, most of prior studies on this aspect are confined to one or two stakeholder groups or consider only internal stakeholders of the company. For example, Nam and Nam (2004) examine the directors' opinion on various corporate governance aspects of four Asian countries where as the survey of McKinsey Co (2002) is confined to institutional investors. In order to address this limitation, this survey uses seven groups including both internal and external stakeholders.

4.6.1 Selection of the Sample

Since the purpose of conducting questionnaire survey is to find out perception of stakeholder groups of companies, an attempt is made to incorporate key stakeholder groups who could make substantial contribution, either directly or indirectly, towards the reforms of corporate governance policies in Sri Lanka. After having careful

examination of various stakeholder groups in other studies (Mckinsey, 2002, Nam and Nam, 2004, Ho, 2005) and considering the Sri Lankan situation, it is decided to use seven influential stakeholder groups who are instrumental in implementation, monitoring, or policy formulation of corporate governance. These groups are: Non-executive Directors (NED); Independent Audit Professionals (IAP); Accountants (ACC); Government Policy Makers (GPM); Government Audit and Tax Officers (GATO); Academics (ACD); and Investors (INV).

The sample is drawn from the employees representing first six groups and investors who are located in Colombo, the business capital of Sri Lanka. Considering the difficulties in getting responses to questionnaire survey, two methods are adopted in distributing and collecting questionnaires. The first method is to distribute and collect the questionnaire by the researcher himself and through a number of persons with whom the researcher has personal contacts. Based on this method 290 copies of questionnaires were distributed among prospective respondents of IAP, GMP, GATO, and ACD groups during January and February 2010. The second method employed is a mail survey in which 375 copies were mailed to the Home/Office addresses of the prospective respondents of NED, ACC and INV groups. The questionnaires were sent with a covering letter addressed to personal name of the recipients and a postage-paid reply envelope.

A sample of 150 non-executive directors was selected from public listed companies. The questionnaires were mailed to them using same address data base developed for corporate governance compliance survey. Their names were extracted from the websites of respective companies. Accordingly, 150 copies were mailed to their office addresses. The sample of accountants was also chosen from public listed companies. The questionnaires were mailed to the accountants of randomly selected 125 companies using same address data base. The sample of 100 investors was selected using the information obtained from the CSE. The questionnaires were mailed to their home or office addresses depending on the availability of information.

The independent audit professionals comprise partners, qualified managers and senior audit assistants of the audit firms. The sample of 70 audit professionals was drawn from two leading audit firms. The questionnaire was distributed personally with

the assistance of senior partners of these firms (Ernest & Young and KPMG). The government policy makers include the employees of three leading government organizations namely; the SEC; the Treasury of Sri Lanka and the Central Bank of Sri Lanka. The sample of 80 employees was drawn from the staff grade officers of these institutions and the questionnaire was personally distributed among them. The government audit and tax officers consist of the audit officers (audit superintendents) of the Auditor-General's Department of Sri Lanka and the tax officers (assessors) of the Inland Revenue Department of Sri Lanka. The questionnaire was personally distributed among the sample of 100 officers of these organizations. The sample of academics comprises of 40 senior lectures/lectures from the management and commerce faculties of University of Sri Jayewardenepura and University of Colombo, Sri Lanka. The selected lectures were handed over the copies of the questionnaire personally based on the researcher's long standing working relationship with these universities.

Every attempt was made to obtain a high response rate for the questionnaire with a view to minimise the effect of non-response bias. As for the mailed questionnaire, the remainder letters were posted approximately three weeks after the first post of questionnaires. The same questionnaire was developed into digitally answerable format and sent through e-mails where email addresses of intended recipients were available. As for personally distributed questionnaire, the researcher himself visited the respondents' working places to collect completed copies of the questionnaire. Since some respondents did not return the completed questionnaire in the first attempt, several visits had to be repeated. However, even after several visits some respondents did not return the completed questionnaire and in some cases prospective respondents were not contactable.

4.6.2 Data Collection and Questionnaire Design

The study uses a questionnaire on a 5-point Likert scale to collect primary data from the seven stakeholder groups selected for the sample about their perceptions of the several aspect of corporate governance in Sri Lanka. The major aspects of interest to the study are: important components of corporate governance system; performance implications of corporate governance; present status of corporate governance; major issues of corporate governance; corporate governance strategies; corporate governance practices that need improvement; key players and promoters of corporate governance

and alternative approaches to promote corporate governance practices. The questionnaire is designed to collect information on these aspects in Sri Lankan context.

The development of the questionnaire has undergone two stages. In the first stage main aspects of corporate governance have been identified by reference to corporate governance guidelines and prior research studies as discussed in Section 2.4. In the second stage specific questions were developed by reference to these guidelines and prior research studies (Mckinsey, 2002, Nam and Nam, 2004, Ho, 2005, KPMG in Sri Lanka, 2007). Additional questions were also developed to suit to the context of the study. The questionnaire consists of seventeen questions classified under five parts namely; participant information; important components and performance implications; current status and major issues; strategies and practices; key players and promoters, and personal information of respondents (refer Appendix 8).

Part I of the questionnaire is designed to gather general information about the respondents. In seven questions in Part I, the respondents are asked to tick the appropriate answer box for each question. The questions 1 to 5 focus on the participants' occupations, gender, professional qualifications and educational background where as questions 6 and 7 focus on their share investment information and company directorship experience. Ten questions are given in Part II to Part V. Seven questions of these require respondents to indicate their perceptions of the agreement or the importance on a 5-point Likert scale. The scale for each of these items range from 1 (strongly disagree/ less important) to 5 (strongly agree/more important). These questions consist of 69 items focusing on various aspects of corporate governance. The remaining three questions allow respondents to make their own comments. One such question requires respondents to choose from the given options and the other two are open ended questions which seek respondents' opinion in their own initiation.

In Part II question 8 is designed to evaluate stakeholder perception on the importance of corporate governance components. The question includes both internal and external corporate governance mechanisms with a view of assessing stakeholders' broader understanding of corporate governance. Question 9 focuses on the performance implication of corporate governance. This question comprises eight performance indicators covering financial, market and social performance in order to assess

respondents' opinion on broader aspect of performance implications. These questions are adopted from the studies of KPMG of Sri Lanka (2007), Nam and Nam (2004) and Ho (2005).

The aims of Part III (question 10 and 11) are to investigate current status and major issues of corporate governance in Sri Lanka. As most of the corporate governance issues in Asian countries are similar in nature (Nam and Nam 2004) this question is adopted from the studies of Nam and Nam (2004) and Ho (2005). Questions 12 and 13 in part IV aim to assess the appropriate corporate governance strategies and practices as per stakeholders' point of view. Question 12 recognizes six strategies that can be adopted to improve good corporate governance practices based on general governance literature. Question 13 list fourteen specific practices which are designed based on OECD (2004) principles. Question 14 in Part V examines the key players who involve in promotional activities of corporate governance in Sri Lanka. These players have been recognize by reference to legal and institutional framework of corporate governance in Sri Lanka (refer Section 3.2 and 3.3). Questions 15 to 17 are designed to allow stakeholders to provide their own opinion on corporate governance approaches, issues and recommendations.

4.6.3 Methods of Data Analysis

This section discusses the analytical techniques used in examining respondents' perception on corporate governance in Sri Lanka. The questionnaire include seven questions with 69 items on a 5-point Likert scale to collect primary information from seven stakeholder groups about their perception on corporate governance. The analysis of data is carried out on seven aspects of corporate governance considered in the study.

The responding bias is first assessed prior to the analysis of stakeholders' perception. The significance of non-response bias is evaluated by comparing the differences in responses between early respondents and late respondents of the survey (Innes and Mitchell, 1995). The survey data in respect of each corporate governance aspect is analysed using percentage and mean analysis. The average score of each item is calculated for overall sample and the sub sample of seven groups separately to assess the pattern of respondents' perception on the given issues. The percentage of agreement or disagreement is also analysed for both overall sample and sub samples separately for

each items. Both 4 and 5 answers are considered agreed while both 1 and 2 answers are considered as disagreed in ascertaining agreed and disagreed percentages. The Kruskal-Wallis test is carried out for all 69 items listed in the questionnaire to find out whether there are significant differences among seven stakeholder groups with regard to each issue addressed in the survey.

The responses to open ended questions, which seek respondents to identify major corporate governance issues and to make recommendations to improve the corporate governance practices of Sri Lanka, are investigated using content analysis. The major issues recognized by the respondents are summarised by counting various aspects of the issues. These issues are classified under several themes based on the summary result of counting. The most referred issues are provided as the basis for recognizing themes. The final evaluation of issues is carried out with each of the themes in order to assess the severity of the issues as per stakeholders' point of view. A similar approach is adopted in evaluating recommendations made by respondents in respect of corporate governance practices in Sri Lanka. The major themes of recommendations are identified through the content analysis. The most referred similar recommendations are formed into groups in recognising major themes of recommendations. An evaluation of recommendations is carried out for each theme in order to assess its importance.

4.7 The Impact of Ownership Concentration on Firm Performance

4.7.1 The Sample and the Sample Selection

The study considers the impact of ownership concentration on the firm performance of non-financial companies listed in the Colombo Stock Exchange (CSE) of Sri Lanka. The sample includes all industrial sectors of the CSE, excluding the bank, finance and insurance sector. This sector is excluded from the initial sample due to non-comparability of applicable regulations concerning share ownership concentration, profitability measures and liquidity assessment compared to other sectors. The sample period of the study is nine years from 2001 to 2009. As per the CSE website, 232 companies including 30 financial companies are listed on CSE in 2010. Thus, initial sample included approximately 200 companies per year.

4.7.2 Data and Data Collection

The data for the study are obtained from three main sources: OSIRIS database; database of CSE which provides share price information of Sri Lankan stock market and the annual reports of sample companies. The major items of interest to this study are balance sheets, income statements, ownership structure, shareholdings of main shareholders and the market prices of shares. The balance sheet, income statement and share ownership information are obtained from the OSIRIS database. The information on ownership structure (individual vs. institutional ownership) and the ownership of ten largest shareholders are obtained from the annual reports of sample companies. The market share price information of sample firms is obtained from the database of CSE.

4.7.3 The Variables: Definition and Measurement

As this study aims to explore the diverse performance implications of ownership variables, both accounting and market performance measures are alternately employed as the dependent variables in the analysis model. The ownership variables consist of both ownership structure and ownership concentration variables. The literature generally recognizes additional independent variables that have explanatory power when examining firm performance and corporate governance (Demsetz and Villalonga, 2001, Hovey et al., 2003, Zeitun and Tian, 2007). The performance of company depends on various factors such as operational efficiency, size of the firm and financial risk. To control the effect of these factors three control variables are also included in the data analysis model. These control variables represent size, operational experience and leverage of the sample firms. The size is represented by total sales while the operational experience is represented by the age of the firm. The financial risk is measured using leverage of the firm. These control variables are well established and are the most commonly used control variables in prior studies (Demsetz and Villalonga, 2001, Hovey et al., 2003, Zeitun and Tian, 2007). The definition and measurement of variables and the prior expected signs of the independent variables are described below.

Performance: The return on assets (ROA) and return on equity (ROE) are employed as the accounting performance measures while proxy Tobin Q (TQ) and market to book-value ratio (MBR) are used as the market performance measures in the study. These performance variables were measured using pooled data of sample companies for the sample period of 2001- 2009 as given below.

ROA: Net profit before tax to total assets

ROE: Net profit after tax to total equity

TQ: The market value of a firm's equity plus the book value of its debt to the book value of total assets.

MBR: Market value of a firm's equity to its book value

As the performance measures, accounting and market variables have their inherent strengths and limitations and therefore both accounting and market measures are employed in the study. Both accounting and market performance measures are concurrently used in most previous empirical studies which examine the performance implication of ownership concentration (Demsetz and Lehn, 1985, Morck et al., 1988, Agrawal and Knoeber, 1996, Demsetz and Villalonga, 2001, Thomsen et al., 2006, Kapopoulos and Lazaretou, 2007). They argued that the accounting and market performance measures are varied at least in two important respects. The first relates to the time horizon: accounting profit is based on the historical performance of the firm, and is therefore a backward-looking measure; while market performance reflects the investors' expectation, and is therefore a forward-looking measure. The second difference arises due to measurement problems: accounting profit is largely distorted by accounting principles, concepts and standards. In contrast, TQ and MBR are based on market values, and therefore are affected by investors' expectations about future events, which are subject to manipulations, signalling, group behaviour, and mistakes (Kapopoulos and Lazaretou, 2007). As this study aims to explore the diverse performance implications of compliance to corporate governance practices, both accounting and market performance measures are alternately employed in the analysis.

Ownership Concentration and Structure: Ownership concentration (OC) is measured using four variables: (1) the percentage of shares held by first three-largest shareholders (SH_3); (2) the percentage of shares held by first five-largest shareholders (SH_5); (3) the percentage of shares held by first ten-largest shareholders (SH_{10}); and (4) the Herfindahl Index (HERF). The HERF index, which is the sum of squared percentage of shares controlled by each of the top-five shareholders, can be considered a special concentration variable, because it lends more weight to larger shareholders.

Similarly, the ownership structure (OS) is measured using two fraction ratios: (1) the fraction owned by individuals (F-Ind), and (2) the fraction of shares owned by institutions (F-Com). The prior research studies argued that the ownership concentration by individuals rather than institutions tends to produce better performance. These studies claim that individual owners (compared to corporate owners) are actively engaged in operational activities or are highly influential in monitoring the functions of firms. As a result, agency costs are expected to be reduced resulting in higher performance (Jensen and Meckling, 1976, Zeitun and Tian, 2007, Kapopoulos and Lazaretou, 2007). In order to examine this assertion, the ownership structure ratios are employed as separate variables in the analysis model.

In order to examine the impact of ownership concentration on firm-performance the ownership concentration with 10 largest shareholders are considered. The variables are estimated based on the findings of relevant prior studies which are given in Section 4.7.3 (Demsetz and Lehn, 1985, Morck et al., 1988, Agrawal and Knoeber, 1996, Demsetz and Villalonga, 2001, Thomsen et al., 2006, Kapopoulos and Lazaretou, 2007). The types of ownership (such as family, foreign, individual, institutional etc.) are not considered in estimating concentration variables as only the ownership concentration is considered in the investigation.

The main argument in relation to the influence of OC on firm performance is that a high concentration improves performance through the reduction of agency costs. For example, Berle and Means (1932) argue that disperse ownership adversely affects firm performance. In consistence with this assertion, Shleifer and Vishny (1986) argue that ownership concentration may improve performance by reducing the problem of small investors and decreasing monitoring costs. As such the agency theory assumes a positive relationship between performance and OC of a firm.

The studies that examine the performance implication of ownership structure claim that higher individual ownership leads to higher firm performance whereas higher corporate ownership leads to poorer firm performance. This is achieved through individual owners' monitoring capabilities and incentive to pursue personal interest. When individuals own majority of shares of a firm, they are more likely to be involved in monitoring of operational activities. Also, they may become insider owners who

always pursue their own interest leading to better overall performance. Both situations have a positive influence on the better performance of the firms. Jensen and Meckling (1976) argue that relative to the amount of ownership, insider owners have incentives to pursue activities to serve their own interests, and conclude that both a firm's value and its performance increase with the level of insider ownership. Conversely, if corporate entities own shares, their ultimate owners are less likely to be capable of monitoring firm performance, due to their indirect ownership. Thus, individual ownership is expected to have a positive relationship with performance whereas institutional ownership is expected to have negative relationship.

Leverage: The leverage is represented by total debt to total assets (TD/TA) ratio. The leverage is expected to relate negatively to firm performance, because debt exposes firms to a higher risk through refinancing and the cost of capital commitments. However, agency theory assumes either a positive or a negative relationship between performance and leverage of a firm.

Firm Size: Firm size is measured using log total sales (LN TSal) of sample companies. The size is expected to have a positive influence on firm performance since larger firms perform better than smaller firms through economies of scale and are resilient during economic downturns, leading to consistent performance both in terms of accounting profit and market return. A number of studies examining the impact of firm size on firm performance found a significant positive relationship between the two (Gleason et al., 2000, Zeitun and Tian, 2007) while some studies (Durand and Coeurderoy, 2001, Tzelepis and Skuras, 2004) found positive but insignificant impact of firm size on the firm's performance.

Age: The operational experience of the firm is represented by the age of the firm. It is measured using log age (LN-Age) of the sample companies and is expected to be positively related to the performance, because experience reduces operational costs via economies of scale and the operational processes efficiencies.

4.7.4 Methods of Data Analysis

Based on the assumed causal relationship the regression analysis is carried out to measure the impact of ownership concentration on the firm performance. The analytical

framework of the study hypothesizes that the performance (variously measured) of firm *i* in period *t* depends upon the ownership concentration and structure of firm *i* in period *t* along with other additional independent variables which are directly relevant to the performance of firm *i* in period *t.* The analysis is carried out on the premise of agency theory which argues ownership concentration and individual shareholders share ownership make positive impact on firm performance. The analytical model is specified below.

$$Y_{it} = \beta_0 + \beta_1 X_{1it} + \beta_2 X_{2it} + \beta_3 X_{3it} + \beta_4 X_{4it} + \beta_5 X_{5it} + u_{it} \qquad \text{Pooled Model}$$

Where, Y_{it} is alternately ROA, ROE, TQ, and MBR for firm, as a measure of performance of firm *i* in year *t*.

X_1 = OC (alternately one of the concentration variables)

X_2 = OS (alternately F-Ind and F-Com)

X_3 = Size (LN-Tsal)

X_4 = Age

X_5 = Leverage (TD/TA)

u_{it} = residual error of firm *i* in year *t.*

As stated earlier, there are theoretical arguments and empirical evidence that the ownership concentration and structure of a firm affects its performance. In investigating the effect of ownership concentration and structure on the performance of Sri Lankan companies, a pooled model is estimated assuming no firm or time specific effects on firm performance. The central regression assumption of pooled model is that the independent variables and the error term are uncorrelated. If the independent variables correlate with the error term (endogeneity), the estimates are biased. This is a limitation of the analytical method employed in the study.

4.8 Summary

This chapter dealt with the research design and the methods used in examining the objectives of the study. It described in detail the sample, the methods of data collection, measurement of variables and the methods of data analysis used in relation to three empirical investigations carried out in the study. The survey on compliance to

corporate governance practices is carried out on a sample of quoted public companies in Sri Lanka. This questionnaire survey is administered among the chairman or the CEO of the sample companies. In order to examine the level of compliance to corporate governance practices and its impact on firm performance, a Corporate Governance Index is developed in the study. In the second investigation, stakeholders' perception on corporate governance practices and issues are surveyed. The sample consists of seven stakeholder groups who are directly or indirectly involved in implementing or monitoring of corporate governance practices in Sri Lanka. In the third investigation, impact of ownership concentration on firm performance is examined based on a sample of quoted public companies in Sri Lanka. A combination of quantitative and qualitative methods is used in data analysis. These methods include descriptive statistics, frequency analysis, percentage analysis, non-parametric tests, correlation analysis, regression analysis and qualitative interpretations. Chapters Five, Six and Seven presents the analysis of the study carried out based on these methods.

Chapter 5 : Survey on Compliance to Corporate Governance Best Practices: Analysis, Results and Performance Implications

5.1 Introduction

This chapter presents the empirical analysis and findings of objectives two and three of the study. The data collected from the questionnaire are analysed and discussed. First, the survey responses and problems of data collection are examined, and non-response bias is analysed in order to observe the validity of the findings. Secondly, the influential characteristics of the respondents and their firms are examined. Thirdly, the nature, level, and associated issues of corporate governance practices of the responding companies are analysed across eight dimensions of this study. Finally, the impact of the level of corporate governance on accounting and market performance measures of the sample companies is examined. In order to analyse the performance implications of corporate governance compliance, the sample is divided into two sub samples: high compliance; and, low compliance, based on the constructed index ranking.

5.2. Survey Responses and Data Limitations

All 230 listed companies, excluding delisted companies as per the listing schedule of the Colombo Stock Exchange (CSE) website in 2009, have been selected as the initial sample of the study. The questionnaires were mailed to either the Chairman or the Chief Executive Officer (CEO) of these companies. In total 230 questionnaires were sent to the personal names of the recipients, and they were asked to return the questionnaire by mail. Several approaches were adopted to improve the response rate. The questionnaire could be completed by either the CEO, or the Chairman, or a suitable representative on their behalf. Reminder letters were posted approximately three weeks after the first posting of the questionnaires. The same questionnaire was developed into a digitally answerable format, and sent by e-mail where email addresses of intended recipients were available. Further, the assistance from senior partners of two leading audit firms in Sri Lanka was obtained to distribute questionnaires among CEOs, using their capacity as audit partners of these companies.

5.2.1 Survey Responses

Sixty-three responses were received, and out of these responses sixty questionnaires are usable as they completed all questions. This is a response rate of 26 per cent. Four recipients sent letters indicating that they did not answer the questionnaire because of their company's policy of non-participation in questionnaires. Table 5.1 provides summary information of the firms in each industry sector to which questionnaires were sent, and those numbers of firms that responded. In most industry sectors the response rate is above 30 per cent. Some questions require detailed knowledge of the company, and its board's proceedings. Thus, it was important to ensure that the survey was completed by a knowledgeable person. Of the sixty respondents, forty-six were a board member of their respective companies, and the rest are senior managers (Refer Table 5.3). It is inferred that most of the respondents have a full understanding of their company and their board's proceedings, which is the central focus of the questionnaire.

Table 5.1 Firms Surveyed and Response Rates.

Sector	Number of firms		
	Firms in the Sector & Surveyed	Responded	% of Surveyed
Bank Finance and Insurance	33	10	30.30
Beverage Food and Tobacco	18	6	33.33
Chemicals and Pharmaceuticals	9	3	33.33
Construction and Engineering	3	2	66.67
Diversified Holdings	11	5	45.45
Hotels and Travel	30	8	26.67
Manufacturing	31	8	25.81
Motor	7	3	42.86
Plantation	18	6	33.33
Trade, Services and Supplies	31	9	29.03
Other Industry Sectors	39	0	0.00
Total	**230**	**60**	**26.09**

Of the 60 respondent companies, nine firms belong to different sectors according to the sector categorization of the CSE. These nine firms belong to: Stores and Supplies; Services; Footwear and Textiles; and, Trading Sectors. In this study, these firms are regrouped into one sector, as Trade Services and Supplies, considering similarities in their business operations. The sample of 60 companies is obtained from all actively trading listed companies representing 26% of the market. The sample is spread across

13 sectors of 20 sectors as per the sector categorization of the CSE. Thus, the sample can be considered as a representative sample of the market. Further, as the analysis of survey is carried out primarily using descriptive research method, the sample is adequate for achieving objectives of the study.

5.2.2 Non-responding Bias

One of the major problems of a survey is sample selection bias. Selection bias can enter into the results in two ways: in the choice of firms selected for the survey; and, in which firms responded (Balasubramanian et al., 2007). The scope of this study is the governance practices of quoted public companies in Sri Lanka. The entire population of quoted public companies on the Colombo Stock Exchange were included in the initial sample. The overall response rate is 26 per cent, but respondent firms could differ systematically from non-respondent firms. For example, firms with strong compliance to corporate governance best practices could be more likely to respond to the survey. Hence, any existence of non-respondent bias was evaluated by comparing the respondent companies (60) with a sample of non-respondent companies. Of the non-respondent firms, a sample of 104 firms is matched with respondent firms from the same industrial sectors. The firms are randomly selected. Data for calculating both financial and governance variables are obtained using the *OSIRIS Database* and annual reports of the firms.

Table 5.2 Comparison of Responded and Non-responded Firms

	Respondent	Non-Respondent	Mean difference	t - statistics	Sig. (2-tailed)
Number of Companies	60	104			
Financial Characteristics (Mean)					
– Total assets (Rs. 000's)	8,215,837	7,093,708	1,122,129	0.282	.778
– Market capitalization (Rs. 000's)	3,569,057	3,392,608	176,448	0.075	.940
– ROA (%)	4.56	3.34	1.21	0.620	.536
– Tobin Q	1.15	1.09	0.07	0.758	.450
– Leverage (TD/TA)	0.60	0.50	0.11	1.601	.111
Governance Characteristics					
– Average Board Size	7.9	7.6			
– Non-Executive/Total directors (%)	32.17%	45.84%			
– CEO separate from Chairman	75%	75%			

Table 5.2 provides a comparison of the means of the financial variables: total assets, market capitalization, return on assets (ROA), Tobin's Q and leverage; and, governance variables average board size, percentage of non-executive directors on the board, and if the CEO is separate from the Chairman, for the respondent and non-respondent firms. In order to find out whether there is a significant difference between the two samples, the independent sample T-test for mean difference was carried out in respect of the financial variables. On the whole, the financial characteristics of respondent and non-respondent firms were similar. The t-tests for mean differences for any of the variables are not statistically significant. As indicated in Table 5.2, the governance characteristics are also closely resembled. These results suggest that there is no non-responding bias in the survey. This further suggests that the responses in this study can be regarded as a representative sample of the population.

5.2.3 Other Data Limitations

It is possible to have other data limitations owing to inherent deficiencies of this kind of questionnaire survey. Incomplete knowledge of respondents and self-reporting bias are generally considered as weaknesses of a questionnaire survey. If the respondents do not have proper knowledge about the issues addressed in the questions, the responses may lead to a missing or 'don't know' answer. Nevertheless, in this study all the survey questionnaires (except three which were omitted from the analysis) were received without missing, incomplete or ambiguous answers. This is due to the respondents' capacity in their respective firms. Of sixty respondents, forty-six are board members of their respective firms. Therefore incomplete knowledge of the respondents is assumed to be not a major issue in the survey. However, whether the respondents have reported with bias cannot be assessed directly. This can be measured using indirect measures such as responses' diversity, percentage of negative answers especially in respect of legally obligatory practices, and annual report disclosures. The survey responses are largely varied across the firms. Further, a high percentage of negative answers (on average 28 per cent) in respect of compliance to corporate governance best practices are also found in the responses. This indicates that the bias is not severe. Furthermore, responses for some governance variables can be confirmed using annual report data. The random check is affected wherever possible, and shows no systematic differences between the two sources.

5.3 Profile of Respondents and Respondent Firms

5.3.1 Profile of Respondents

The questionnaire was administered among the chairmen or the CEOs of companies listed on the CSE, who delegate the survey to a suitable representative to complete on their behalf. The analysis of the offices held by the respondents is given in Table 5.3. Of the sixty respondents, 56 per cent represent chairmen and CEOs, whereas 20 per cent of respondents represent either executive or non-executive directors. Thus, in total 76 per cent of respondents were board members.

Table 5.3 Respondents Official Capacity and Professional Background

Office Held	Number	Percentage
Chairman	10	16.67
CEO/Managing Director	24	40.00
Executive director	8	13.33
Non-executive director	4	6.67
Company Secretary	3	5.00
Senior Manager	11	18.33
Total	**60**	**100.00**
Professional Background		
Business executive	15	25.00
Accounting or Financial professional	28	46.67
Lawyer	1	1.67
Other professional	8	13.33
Other	8	13.33
Total	**60**	**100.00**
Gender		
Male	55	91.67
Female	5	8.33
Total	**60**	**100.00**

Source: Questionnaire Survey

Furthermore, an analysis of the professional background of the respondents indicates that a majority (46 per cent) of the respondents are accounting professionals (see Table 5.3). The Sri Lankan Corporate Governance Code (2008) requires firms to have at least one board member with financial or accounting expertise. As the majority of respondents are accounting professionals, most of the firms surveyed comply with the said requirement. As most of the respondents are qualified professionals, the questionnaire responses are considered valid.

5.3.2 Profile of Respondent Firms

Table 5.4 provides a profile of the surveyed companies, giving an indication of their size, operational experience and profitability. This shows a significant dispersion amongst sample companies in respect of: size, as measured by total assets and sales; age; and, profitability. The total assets of the sample companies over the 2009/10 reporting period range from 30 million rupees to 261,990 million rupees, showing a substantial disparity, while the average total assets of the surveyed companies is 8,215 million rupees. The total assets of a sizeable proportion of these companies (43 per cent) were less than 2,500 million rupees. A similar situation emerges when the size of the companies is measured in terms of sales, which vary from 36 million rupees to 54,763 million rupees. This also shows a substantial disparity between the sample companies.

Table 5.4 Profile of the Respondent Firms

Total Assets

Rs millions	Frequency	%
0–500	3	5.0
501–1000	6	10.0
1,001–2,500	17	28.3
2,501–5,000	14	23.3
5,001–10,000	6	10.0
>10,000	14	23.3
Total	60	100.0
Descriptive statistics		**Rs millions**
Mean		8215
Standard deviation		36661
Minimum		30
Maximum		261990

Sales

Rs millions	Frequency	%
0–100	3	5.0
101–500	9	15.0
501–1,000	6	10.0
1,001–2,500	14	23.3
2,501–10,000	17	28.3
>10,000	11	18.3
Total	60	100.0
Descriptive statistics		**Rs millions**
Mean		7020
Standard deviation		12012
Minimum		36
Maximum		54763

Age

Years	Frequency	%
0–5	1	1.7
6–15	6	10.0
16–25	18	30.0
26–50	20	33.3
51–100	11	18.3
> 100	4	6.7
Total	60	100.0
Descriptive statistics		**Years**
Mean		38
Standard deviation		31
Minimum		5
Maximum		142

ROA

Per cent	Frequency	%
−10 – 0%	13	21.7
0 – 2.5%	12	20.0
2.5 – 5%	12	20.0
5 – 10%	12	20.0
10 – 15%	6	10.0
> 15%	5	8.3
Total	60	100.0
Descriptive statistics		**Per cent**
Mean		4.56
Standard deviation		9.62
Minimum		-8.29
Maximum		46.75

Source: Annual Reports (2009/10) of respondent firms

The sample of companies consists of both young and old enterprises, with their age ranging from 5 to 142 years. 42 per cent of companies in the sample are under 25 years old, while only 25 per cent of companies are over 50 years old at the time of the survey. As for the profitability level of companies, once again there is a wide disparity. While 47 firm-years in the sample reported positive returns, the remaining 13 firm-years reported negative returns on their assets from the sample period. The average profitability ratio of the sample companies was 4.56 per cent, while the majority of companies (61 per cent) earned less than 5 per cent return on their assets.

5.3.3 Ownership Concentration, Structure and Control of Respondent Firms

The ownership concentration of sample firms is evaluated using four variables: namely: first the percentage of shares held by the largest shareholders (SH1); secondly the percentage of shares held by the first two largest shareholders (SH2); thirdly the percentage of shares held by the first five largest shareholders (SH5); and, fourthly the percentage of shares held by the first ten largest shareholders (SH10). These variables are measured based on the twenty largest shareholders' share ownership schedule published in the annual reports of respondents' firms for the year 2009/10. The frequency distribution of these variables is given in Table 5.5, and shows a very high ownership concentration in the sample of Sri Lankan firms. The mean value of SH1 is 48 per cent while the mean values of all other concentrations of variables are above 60 per cent, with a maximum mean value of 83 per cent. The data also indicates that there is a substantial variation in ownership concentration across firms, from a minimum of 11 per cent to a maximum of 98 per cent. Furthermore, the data in Table 5.5 reveals that the first 10 largest shareholders of 65 per cent of the sample firms hold over 80 per cent of the shares. This indicates that a majority of firms are not in compliance with the CSE listing rule requirement which stipulates that a minimum float of 25 per cent of shares should be held by at least 1000 shareholders.

The analysis of the frequency distribution (see Table 5.5) further shows that for 48 per cent of the firms surveyed, the largest shareholder owns over 50 per cent of the share capital. In 70 per cent of the firms, the largest two shareholders own over 50 per cent of the share capital. If the ten largest shareholders are considered, this number becomes 97 per cent. This indicates the presence of a controlling shareholder in most Sri Lankan firms surveyed. The prevalence of a single controlling shareholder in the

majority of sample companies indicates that quoted public companies with diffuse share ownership are lacking in Sri Lanka. This finding is consistent with previous studies. Samarakoon (1999) examines the ownership structure of 222 out of 240 listed companies in Sri Lanka during the financial year 1997/1998 and provides evidence of the presence of a controlling shareholder in most of the companies. This is a common phenomenon in many parts of the world. For example, La Porta et al. (1999) report that ownership structure is generally not dispersed in 27 wealthy economies in the world. They show that even the largest firms tend to have controlling shareholders and these controlling shareholders typically have considerable control over firms in excess of their cash flow rights. Faccio and Lang (2002) also find that in 55 per cent of Western European companies shares are not widely held and have a single ultimate owner.

Table 5.5 Frequency Distribution of Share Ownership Concentration

Table shows frequency distribution of ownership concentration with the largest shareholders. The types of ownership such as family, foreign, individual or institutional are not considered in estimating concentration variables

Concentration of Share Capital (Range)	Largest Shareholder (SH1)		Two Largest Shareholders (SH2)		Five Largest Shareholders (SH5)		Ten Largest Shareholders (SH10)	
	Frequency	%	Frequency	%	Frequency	%	Frequency	%
0% - 20%	4	6.67	0	0.00	0	0.00	0	0.00
21% - 40%	18	30.00	8	13.33	2	3.33	0	0.00
41% - 50%	9	15.00	10	16.67	1	1.67	2	3.33
51% - 60%	12	20.00	12	20.00	6	10.00	1	1.67
61% - 70%	4	6.67	8	13.33	9	15.00	3	5.00
71% - 80%	8	13.33	8	13.33	15	25.00	15	25.00
Over 80%	5	8.33	14	23.33	27	45.00	39	65.00
Total	**60**	**100**	**60**	**100**	**60**	**100**	**60**	**100**
Descriptive Statistics								
Minimum		11.07		20.70		30.27		41.49
Maximum		93.46		93.81		98.33		98.77
Mean		48.09		61.45		76.59		83.06
Std. Deviation		21.97		19.53		15.13		11.95

Source: Annual reports 2009/10: Twenty largest shareholders' share ownership schedule

In addition to ownership concentration, ownership structure in terms of family or foreign shareholdings is another important factor to consider in evaluating the observance of good corporate governance practices by respondent firms. In this study, specific questions are focused on ownership structure and control, in terms of a firm's

family and foreign shareholdings, and any controlling shareholder's influence on the decision making processes of the firm. In Sri Lanka, the *Company Takeovers and Mergers Code* of 1995 stipulates ownership limits of quoted public companies, and the *Banking Act* No. 30 of 1988 defines ownership limits of banks. According to the direction given by the Sri Lankan Monetary Board under section 46(1) (d) of the *Banking Act* No. 30 of 1988, no person or company may hold more than 15 per cent of issued share capital carrying voting rights in a licensed commercial bank incorporated in Sri Lanka. The *Company Takeover and Merger Code* of 1995, as amended in 2003, imposes restrictions on acquiring a large block of shares of a company where the target company is a public limited company. The purpose of this Code is to ensure fairness for all shareholders, especially for non-controlling shareholders in relation to a takeover. Despite these regulatory limitations, concentration of ownership is a common characteristic of most Sri Lankan listed companies. Concentrated ownership gives a few individuals the ability to control the activities of the firm, which could have a negative impact on: the firm's compliance to best practices of corporate governance; the protection of minority shareholders' rights; and, the growth of the capital market. Hence, it is interesting to know how ownership concentration in conjunction with family or foreign shareholding has impacted on the compliance to best corporate governance practices. Family ownership concentration has been recognized as one of the dominant characteristics of Asian companies (Nam and Nam, 2004). According to Claessens et al. (2000) two thirds of East Asian firms are controlled by a single shareholding, which is often turns out to be a family. The patterns of family and foreign shareholdings in Sri Lankan firms, and the impacts of this on corporate governance are yet be explored. The impact of family ownership on corporate governance practices could be different to the impact of foreign shareholdings on governance practices. Hence, it is important to explore the pattern of shareholding prior to analysing its impacts on corporate governance. In order to facilitate this, the nature of shareholdings and the control structure of respondent firms are analysed, and the results are given in Table 5.6.

The composition of family ownership patterns found in the sample of companies is given in Table 5.6. It shows that over 33 per cent of companies surveyed are family based. It further reveals that 15 percent of the respondent firms are subsidiaries of family based groups. This indicates that family based business groups use their

subsidiaries as a means of raising funds through the share market, without losing control. This analysis shows that family ownership is prevalent in Sri Lankan quoted public companies, as in the case of other Asian countries. Claessens et al. (2000) show that in family controlled Asian firms, the controlling shareholders often act the managers at the top level of the company. Faccio and Lang (2002) find similar results in family owned companies in Western European countries. They find that in more than two-thirds of family controlled firms, the controlling shareholder acts as a top manager. Family ownership with controlling shareholder representation in top management could have a direct impact on corporate governance and adherence to best governance practices. In order to evaluate the level of compliance of corporate governance practices the sample companies are formed into two groups; family based, and non-family based. The analysis results are given in Section 5.5.

Table 5.6 Nature of the Ownership and the Control Structure of Firms

Nature of the firm and family ownership	Number	Percentage
Family-based stand-alone company	8	13.33
Subsidiary of a family-based group	9	15.00
Holding company of a family-based group	6	10.00
Subsidiary of a non-family based group	15	25.00
Holding company of a non-family based group	22	36.67
Total	**60**	**100.00**
Nature of Foreign ownership and Investment		
There is no foreign investment	20	33.33
There is little ownership by foreign investors	27	45.00
There is substantial ownership by foreign investors	8	13.33
Subsidiary of a foreign firm	5	8.33
Total	**60**	**100.00**
Control Structure: (Parties having greatest influence over the firm)		
The largest shareholder of the firm	35	58.33
Several bulk-shareholders collectively	8	13.33
Board of Directors as there is no dominant shareholders or group	17	28.33
Total	**60**	**100.00**
The existence of a labour union(s) Yes	31	51.67
No	29	48.33
Total	**60**	**100.00**

Source: Questionnaire Survey - Question 4, 5, 6 and 7

The foreign affiliation is determined based on the responses of question 5 in the questionnaire. As shown in Table 5.6, companies with substantial foreign affiliation are

relatively low. 33 per cent of respondents indicated that they had no foreign investment in their companies suggesting that these companies were entirely owned by Sri Lankans. Only 22 per cent of sample firms have substantial foreign affiliations. However, for these companies, foreign affiliation could have a direct impact on management policies and corporate governance practices. Foreign affiliated companies have a tendency to follow governance practices and rules for the protection of shareholder rights more closely, owing to the influence of their parent companies. For the analysis of questionnaire responses, the sample companies are formed into two groups as foreign affiliated companies and local companies, and the analysis results are shown in Section 5.5.

More often than not, Sri Lankan business groups are owned by an individual, a family, or a closely held company as discussed above. The analysis results given in Table 5.6 show that in over 71 per cent of companies, the controlling shareholder(s) has the greatest influence over policies of the firm. This evidence suggests the existence of controlling shareholder(s) for most of Sri Lankan firms. In these firms, the control rights are highly concentrated and the controlling owner has both incentives and the means to expropriate wealth from non-controlling shareholders, as shown in the studies of Claessens et al. (2000) and Bertrand et al. (2008). Hence, these ownership structures allow controlling shareholders to obtain a degree of control disproportionate to their equity ownership. Bebchuk et al. (1999) show that these arrangements have the potential to create very large agency costs, which are larger than the benefit associated with controlling shareholders. Furthermore, intra-group transactions could be used to manipulate reported profits and net worth. Therefore, the critical governance problem in Sri Lankan companies is the protection of non-controlling shareholders from the controlling shareholders' opportunism. Ownership concentration and the dominance of a controlling owner could have a direct impact on corporate governance practices. In order to evaluate these impacts, the ownership concentration is also taken into consideration in exploring the questionnaire responses.

5.4 Analysis of the Survey Results

This section provides a detailed overview of the corporate governance practices of responding Sri Lankan listed firms. As indicated in Section 4.5.2, the analysis of the questionnaire survey is carried out under eight dimensions of governance practices,

namely: board structure and independence; board procedure and effectiveness; directors' remuneration; audit committee procedure; disclosure and transparency; disclosure reliability; shareholders' rights; and, related party transactions.

5.4.1 Board Size, Structure and Independence

The important determinants of board effectiveness consist of board size and composition. A board should have a proper mix of executive and non-executive directors (NEDs), with adequate qualifications and experience to make effective strategic decisions and to judge management's performance objectively. If a board needs to be independent it should consist of a substantial proportion of independent directors. The importance of having a substantial share of NEDs on the board is that they can be assigned tasks where there are potential conflicts of interest, such as financial reporting and board nomination and board remuneration (OECD 1999). The separation of the CEO and chairman positions can be considered as another indication of board independence. Furthermore, the representation of foreign nationals on the board may also be considered as an indication of board independence. In addition to the composition of the board, independent directors' behaviour can be judged to identify their earnest independence in the decision making process. The meeting of NEDs without executive directors to discuss the firm's affairs, and making alterations to board meeting agendas are some examples of independent directors' behaviour which can be used to assess their independence. However, independent directors might not behave independently, if the CEO or controlling shareholder dominates influence over the selection and reappointment of directors. In this study, these aspects have been analysed using survey data of Sri Lankan companies, and the results of the analysis are discussed in the following sections.

Table 5.7 provides information on the size and composition of the boards of responding firms, for which data is obtained from the annual reports of 2009/10. As the responding firms include a sample of 60 companies representing 26% of the listed companies and these companies spread across 13 sectors in the Sri Lankan market the sample provide solid foundation to analyse the composition of Sri Lankan firms. The size of the board of directors of respondent companies ranged from five to fourteen members. The results presented in Table 5.7 show that 17 of the responding companies have seven board members, while 13 of the respondent companies each have eight

board members. The overwhelming tendency is for boards to have six to ten members (86 per cent). Nam and Lum (2005) argue that the most effective size of a board for corporate governance purposes is no more than twelve members. Salmon (2000) suggests that the optimum size of a board is between 8 and 15 people for large, publicly traded companies. Further, he claims that a board is likely to have difficulty in staffing audit, compensation, and other committees if the board members are fewer than eight. The finding that a majority of boards consist of six to ten members could have positive implications for adherence to best corporate governance practices. Furthermore, this tendency could improve the board efficiency as well as the firm's performance.

Table 5.7 Board Composition of Sample Firms

Table shows frequency distribution of number of Total Directors, Executive Directors (excluding CEO) and Nonexecutive Directors with the classification of Non-independent and Independent directors of the sample.

Directors Range	Total Directors	Executive Directors	NEDs	Non-executive Directors	
				Non Independent	Independent
(a)	(b)	(c)	(d)	(e)	(f)
14	1	-	-	-	-
13	-	-	-	-	-
12	1	-	-	-	-
11	3	-	-	-	-
10	5	-	1	-	-
9	9	-	3	-	-
8	13	-	4	1	-
7	17	2	5	3	-
6	8	1	16	3	5
5	3	9	12	5	1
4	-	6	6	13	5
3	-	10	8	8	18
2	-	12	5	10	16
1	-	15	-	6	12
0	-	5	-	11	3
Total	60	60	60	60	60
Mean	7.93	2.63	5.32	2.9	2.44
Median	8	2	6	3	2
Minimum	5	0	2	0	0
Maximum	14	7	10	8	6

Note:
(a) Directors range represents possible number of total directors or each type of directors in a board
(b) Number of companies whose Boards have total directors equal to the number given in (a)
(c) Number of companies whose Boards have executive directors equal to the number given in (a)
(d) Number of companies whose Boards have non-executive directors equal to the number given in (a)
(e) Number of companies whose Boards have non-independent directors equal to the number given in (a)
(f) Number of companies whose Boards have independent directors equal to the number given in (a)

Data Source: Annual reports of responded firms (2009/10)

Principle A.5 of the *Sri Lankan Corporate Governance Code* (SLCGC) 2008 contains minimum board independence requirements. It requires listed firms to have NEDs with sufficient calibre. This principle requires that the NEDs should be at least two or 1/3, whichever is higher, and in the case of CEO duality NEDs should be the majority. If the board has only two NEDs, they must be independent. In all other cases two or 1/3 of NEDs, whichever is higher, should be independent. Table 5.7 suggests that most surveyed firms have managed to find independent directors. The maximum number of independent directors observed in this study is six. Under the principle A5 of the SLCGC (2008), a company must have a minimum of two independent directors. 76 per cent of the respondent companies have at least two independent directors on the board consistent with the minimum requirement stipulated in the SLCGC. However, 24 per cent of the respondent companies have lower than the mandatory number of independent directors. Of these companies, three do not have a single independent director on their boards. This is an obvious violation of the Sri Lankan Governance code. Nam and Lum (2005) point out that low numbers of independent directors have negative implications for corporate governance. Irrespective of lack of independent directors, all responding companies have at least two NEDs on their boards. However, principle A.5 states that NEDs should be at least 2 or 1/3, whichever is higher. The frequency distribution of percentage of different classes of directors to total directors is further analysed in order to find out the compliance to the given rules. The results are given in Table 5.8.

Table 5.8 provides information on the number of boards, with different percentages of executive, non-executive (non-independent) and independent directors. Notable is the high representation of NEDs in Sri Lankan companies. For example, 39 (65 per cent) of companies have more than 60 per cent of directors as non-executive directors on their boards, giving a low representation of executive directors. However, four firms (7 per cent) do not comply with the requirement of at least 1/3 of NEDs in the board. In addition, 29 (48 per cent) of firms have less than 30 per cent of independent directors on their boards. The final column of Table 5.8 shows the number of firms which have separate individuals as CEO and chairman, within a particular range of percentage of independent directors. This indicates that 15 companies do not have separate persons as their CEO and chairman, and out of those companies 12 companies have less than 40 per cent of independent directors on their boards. Though the majority

of companies have more than 60 per cent of NEDs on their boards, 71 per cent of companies have less than 40 per cent of independent directors on their boards. This evidence signifies that a majority of companies maintain a low level of independence on their boards. However, most of the companies comply with the requirements for NEDs.

Table 5.8 Percentages of Different Types of Directors to Total Directors

Table shows frequency distribution of percentages of executive, nonexecutive (non-independent and independent) to total directors of sample Sri Lankan listed firms. Further it shows distribution of separate CEO and Chairman for the range of Independent directors.

% to Total Directors	Executive Directors	Non-executive Directors (NEDs)			Separate CEO and Chairman (Based on Independent Directors Range	
		Independent	Non-independent	Total NEDs	Yes	No
≥0%<20%	21	16	18	0	14	2
≥20%< 30%	11	13	8	4	8	5
≥ 30%<40%	7	14	9	5	9	5
≥40%<50%	8	9	8	9	6	3
≥50%<60%	5	5	5	3	5	
≥60%<70%	4	1	4	8	1	
≥70%<80%	4	2	4	12	2	
≥80%≤100%	0	0	4	19	0	
Total	60	60	60	60	45	15
Mean	33%	30%	37%	67%		
Median	29%	33%	38%	71%		
Minimum	0%	0%	0%	29%		
Maximum	71%	75%	100%	100%		

Source: Annual reports of responded firms (2009/10)

Table 5.9 Board Representation and CEO Duality

Table shows representation of board by various shareholder groups and position of CEO duality

Board Representation:	Yes Number	Yes %	No Number	No %
– Representative(s) of institutional investors	18	30	42	70
– Representative(s) of non-controlling shareholders	24	40	36	60
– Representative(s) of controlling shareholder's family	29	48	31	51
– The board has foreign nationals	23	38	37	62
CEO Duality:				
– Separate persons for the Chairman and the CEO	45	75	15	25
– The board appoints a senior independent director if the same person for the CEO and the Chairman	12	80	3	20

Table 5.9 shows the percentage of responding firms with one or more directors in the indicated categories. Of the 60 responding companies, only 40 per cent of companies indicate that they have non-controlling shareholders' representative(s) on the board. The institutional representation is only 30 per cent. However, the boards often include members of controlling shareholders' families (Claessens et al., 2000 and Bertrand et al.,2008). The inclusion of controlling shareholders' family representatives could have a negative impact on board independence. Bertrand et al. (2008) state that pressure from family members is likely to have negative impacts on the implementation of corporate governance practices, and is likely to cause conflicts of interest. Furthermore, the principle A 5.6 of SLCGC (2008) requires senior independent directors to be appointed, and disclosures of this in the annual reports, in cases of CEO duality. Fifteen companies have stated that their CEO and chairman positions are held by the same person. Out of these, three companies indicate that they have not complied with the A5.6 rule of SLCGC. This evidence further suggests the lack of board independence in some Sri Lankan companies.

Table 5.10 Selection of Non-executive Directors

	Frequency	Percent
Who has the strongest voice in the selection of non-executive directors?		
– Board or its nomination committee (autonomously)	43	72
– CEO	3	5
– Controlling shareholder(s) who is not the CEO	14	23
Total	60	100

Table 5.10 shows the most influential parties in the selection of NEDs. Boards or their nomination committees have a strong voice in selection of NEDs in 72 per cent of the respondent companies. However, the remaining companies indicate that their selection of NEDs is determined by either the CEO or the controlling shareholder. This phenomenon raises reasonable doubt regarding the independence of NEDs.

The characteristics of 'independence' proposed by the regulatory bodies and the proponents of best governance practices are varied. Salmon (2000) recognizes the core characteristics of an independent director as being: free from any significant family or business relationship with the management or with controlling owners; and, free from any relationship with the company in the capacity of employees or representatives of

affiliated companies, suppliers, providers of professional services, and important customers. The Cadbury Report (1992, Code 2.2) advocates: independence from management; and, independence from any business or other relationship with the company as central characteristics of an independent director. However, the OECD (2003) recognizes that precise definitions of independence and legal norms, and rigorous enforcement cannot ensure that independent directors will always act independently.

If the NEDs are selected by the CEO or controlling shareholder, the independence of NEDs is largely at risk. Nam and Nam (2004) state that in most Asian countries, executives as well as NEDs are mostly handpicked by controlling shareholders, and therefore boards of directors in family-based enterprises tend to primarily serve the interests of controlling families, rather than of all shareholders. A similar behaviour is observed in respect of the selection of NEDs in the respondent companies to this study. A relatively high percentage (over 25 per cent) of respondent companies state that the selection process of NEDs is dominated by the CEO or controlling shareholder. Hence, it cannot be expected that the independent directors always act independently in board decision-making processes in those companies. There is a strong possibility that the board's decision making process could be centralized towards the CEO or controlling shareholder. Hence it is inferred that not only the composition of boards, but also the selection process of directors can have negative implications on the independence of boards.

5.4.2 Board Procedure and Effectiveness

The board of directors is expected to provide strategic guidance to the management of a company. The objective of the board is to maximize the value of the firm, and thereby protect the interests of shareholders. The SLCGC (2008) and the *Companies Act* No.07 of 2007 of Sri Lanka recognize the functions and responsibilities of the board of directors quite clearly. In summary, the functions and responsibilities of boards of directors identified in SLCGC (2008, principles A.1.1 and A.1.2) include: to review, formulate and monitor the implementation of strategy; meet regularly (at least one meeting per quarter); ensure the competence of the CEO and management team; adopt an effective CEO and management succession plan; secure an effective information, control and audit system; ensure compliance with legal and ethical

standards; and, ensure the management of risks. Responses were sought to a series of questions regarding the boards' practices and processes including: conduct of board meetings; information about board committees; directors' appointments; and, performance evaluation practices of directors. The results are discussed in the following section.

5.4.2.1 Board Practices

Table 5.11 indicates to what extent the responding firms adhere to recommended board practices. 62 per cent of respondent firms have bylaws to govern board meetings. The remaining 38 per cent of firms have no specific bylaws, which is a major drawback in the procedure of carrying out board meetings. Good governance practices require that companies record detailed minutes of board meetings and committee meetings, as well as any dissenting motions. Nam and Nam (2004) suggest that compiling detailed minutes of board meeting discussions may encourage independent directors to behave more independently, and enhance their performance. The survey results show that 92 per cent of the respondent companies have recorded dissenting views in their minutes, and over 90 per cent of the boards have a schedule of matters reserved for consideration. These practices provide strong evidence regarding the proper conduct of board meetings by Sri Lankan companies. However, the absence of bylaws to govern the board meetings for 38 per cent of respondent companies raises serious doubts regarding the consistent application of board procedures, as these could be violated in a crisis situation.

Table 5.11 Board Practices

Characteristics	Yes		No	
	Number	%	Number	%
– The board has bylaws to govern board meetings	37	62	23	38
– The board has a schedule of matters reserved for its consideration	54	90	6	10
– Dissents recorded in the board minutes	55	92	5	8
– The board has Accounting and Finance professional(s)	56	93	4	7
– Separate meetings for non-executive directors	26	43	34	57
– The board periodically evaluate its performance	47	78	13	22
– Directors' performance assess individually	24	40	36	60

The principle A.4 of SLCGC (2008) requires the board to ensure an availability of financial acumen amongst its members. Having accounting and finance professionals

as board members strengthens governance practices, due to their familiarity with financial and reporting issues. It seems that this requirement has been well adhered to, as indicated by 93 per cent of the sample companies having board members who are accounting and finance professionals.

The lack of independence of non-executive directors seems to be a common phenomenon in the Asian Region. The *OECD White Paper on Corporate Governance in Asia* (2003) reveals that the concept of independent non-executive directors is not a real life experience in Asia, unlike in other regions. To improve the independence of NEDs, SLCGC (2008, principle A.5.8) requires the chairman to hold a meeting with NEDs without executive directors at least once a year. Allowing non-executive directors to conduct separate meetings gives them an opportunity to express their views in an unbiased fashion, without any influence from executive directors. In this study, it can be seen that only 43 per cent of the respondent companies have separate non-executive director meetings.

The SLCGC (2008, principle A9) expects a board to evaluate its own performance, and its committees' performances, in discharging their responsibilities. This study finds that 22 per cent of firms surveyed indicate that they do not evaluate board performance collectively. Furthermore, 60 per cent of the firms state that an individual director's performance is not evaluated. This evidence suggests that it is not crucial for the retention of a director's position on a board to demonstrate the efficient discharging of duties and responsibilities, either individually or collectively as a board.

5.4.2.2 Board Meetings

As a practical matter, how much time and effort directors devote to board meetings may be considered as an indicator of board effectiveness. For instance, the frequency and length of board meetings, and the directors' attendance rate can be used to assess the effective functioning of board meetings. The SLCGC (2008) requires a minimum of four meetings to be conducted per year. However, no such requirements can be found in relation to the duration of board meetings or directors' attendance. Table 5.12 indicates for this study's respondents, the number of board meetings per year, average duration of meetings and the average percentage of directors' attendance at board meetings. Apart from 7 per cent of the respondent companies, all others

complied with this requirement of holding four meetings per year. Similarly 28 per cent hold meetings almost every month. The results further indicate that 48 per cent of the responding companies' meetings have an average duration of two to three hours, while 20 per cent of the companies' meetings have durations of over three hours. Duration of board meetings is an important indicator of good corporate governance, because it infers directors have time to address all relevant issues. Attendance of directors at board meetings is positively related to their governance performance. The survey results indicate that 80 per cent of the responding companies have a directors' attendance rate at board meetings of 90 per cent and above, while only three per cent of companies surveyed have an attendance rate at board meetings below 75 per cent.

Table 5.12 Board Meetings

Number of Board Meetings per year	Frequency	Percent
Less than 4 times	4	7
4 – 6 times	29	48
6 – 10 times	10	17
More than 10 times	17	28
Average duration of Board Meetings		
Less than 1 hour	3	5
1-2 hours	16	27
2-3 hours	29	48
Over 3 hours	12	20
Average Percentage of attendance at Board Meetings		
90% - 100%	48	80
75% - 89%	10	17
60% - 74%	2	3

5.4.2.3 Board Committees

Some specific board functions are performed better if they are carried out by specialized committees consisting of members with expertise in the related field. When there are a number of board members, decision making is not effective in certain circumstances due to conflicts of interest. Thus formulating specific committees facilitates effective decision making by the board. Having recognized the importance of these committees, SLCGC (2008) requires companies to set up three such committees; namely audit, compensation, and nomination committees. The importance of the role of independent directors is also recognized, as these committees deal with conflicts of

interest. Table 5.13 summarizes the findings of this study on the existence, and evidence of the functioning of these committees.

Table 5.13 Board Committees and Frequency of Meetings

	Audit Committee		Remuneration Committee		Nomination Committee	
	Yes	%	Yes	%	Yes	%
Existence of committees	60	100	58	97	27	45
No. of Meetings per year	**Freq.**	**%**	**Freq.**	**%**	**Freq.**	**%**
Once	3	5	29	48	17	63
2 – 3 times	17	28	23	38	8	30
4 – 6 times	35	58	6	10	2	7
More than 7 times	5	8	0	0	0	0
Not Applicable	-	-	2	3	33	-
	60	100	60	100	60	100

It is noted that 100 per cent of the sample comply with the requirement of having an audit committee. The audit committee is actively functioning in the majority of companies. For example, 58 per cent of the responding firms have four or more audit committee meetings per year. Eight per cent were meeting more than seven times per year, and only five per cent were meeting once a year. The frequency of meetings is likely to be a factor in effective monitoring of performance, which enhances the application of other corporate governance practices (Balasubramanian et al., 2007). These results indicate that audit committee meetings are held frequently which is a positive indicator of the effective monitoring of performance in Sri Lankan companies. However, the effectiveness of an audit committee cannot be measured only by analysing the frequency of meetings. Other aspects such as composition, independence and practices also play an important role, and these aspects are analysed separately in Section 5.4.4.

The vast majority of respondent companies (97 per cent) have remuneration committees. The primary function of a remuneration committee is to assist the board in ensuring appropriate and effective remuneration packages and policies for its directors. The existence of a remuneration committee in most of the Sri Lankan firms surveyed is considered a strong indication of good governance practice with regard to directors' remuneration. The frequency of committee meetings is a sound indicator of the active functioning of this committee. Over 50 per cent of the respondents have had two or

more committee meetings per year. 10 per cent were meeting four to six times per year. However, 48 per cent of these committees met only once a year. Hence, the range of frequency of meetings indicates the diverse practice in relation to the active functioning of remuneration committees.

The SLCGC (2008) advocates a transparent procedure for the appointment of new directors and requires that a nomination committee be established to lead the process for board appointments, and to make recommendations to the board. However, only 45 per cent of the responding firms have nomination committees. This is a relatively low percentage when compared with audit and remuneration committees. This behaviour suggests that the appointment of directors is generally dominated by the CEO or controlling shareholder in Sri Lankan companies, as mentioned earlier. Furthermore, the inactive functioning of nomination committees has aggravated the problem of the low prevalence of nomination committees. For example, 63 per cent of nomination committees met once a year. Only 7 per cent had meetings four to six times per year. This indicates inactive functioning of nomination committees in Sri Lankan companies. It is speculated that this suggests a CEO or controlling shareholder dominance in board appointments.

5.4.2.4 Appointment of Directors

It is important that the board has proper balance in terms of executive and non-executive directors, and in terms of the experience, qualities and skills that individual board members are capable of bringing to board operations. The appointment of board members should be objective and free from any influence or bias. Thus, the nomination committee has to play key a role in selecting and making recommendations to the board in respect of board appointments, and in ensuring objectivity of appointments. However, impartiality of the nomination committee is dependent upon its composition, policies and mode of operation. Having recognized the importance of a nomination committee in board appointments, SLCGC (2008) formulates terms of reference for this committee as a separate schedule (Schedule A) to the Code. This requires the majority of nomination committee members to be NEDs. The nomination committee is to be chaired by a NED appointed by the board, and nomination committee minutes are to be circulated among all members of the board. Furthermore, it recognizes major duties of a nomination committee include: proposing a suitable charter for the appointment and re-

appointment of directors; providing advice to the board on appointments; and, regular review of the size, composition and competencies of the board.

Table 5.14 Appointment of Directors

Characteristics	Yes Number	Yes %	No Number	No %
Nomination Committee (NC)				
– NC exists	27	45	33	55
– Firm has written terms of reference governing the NC	19	70	8	30
– NC comprises exclusively of non-executive directors	11	41	16	59
– NC is chaired by an independent director	19	70	8	30
– NC minutes are circulated among all board members	19	70	8	30
– Dissents are recorded in the committee minutes	20	74	7	26
Director terms and appointment				
– All appointments to the board are made only through the NC	22	37	38	63
– Firm has transparent procedures for the election of directors	46	77	14	23
– Directors are subject to re-election at least once in three years	56	93	4	7
– Directors are subject to a limit on the number of directorships in other firms	14	23	46	77

Table 5.14 shows the results of this study relating to the appointment of directors. According to the sample survey only 37 per cent of the firms made all appointments to the board through the committee, although 45 per cent of firms had established nomination committees. This indicates that even if nomination committees are established, they are not in operation fully. Only 70 per cent of the companies had written terms of reference, though proposing a suitable charter is recognized as one of the duties of the nomination committee. In order to express an unbiased view, the independence of the directors is a major component. 41 per cent of the firms had their committees comprising exclusively of NEDs. 70 per cent of the responding firms had their nomination committees chaired by an independent director. 70 per cent circulated minutes among all board members. 74 per cent of the committees recorded dissents in the minutes.

Limiting the tenure of directors to a maximum of three years and limiting the appointment of a single director to different boards indirectly regulate the influence of a director. 93 per cent of the companies surveyed adhere to limiting the tenure of directors, whereas only 23 per cent allow a limit on the number of directorships one can

hold. 23 per cent of the respondent firms stated that they don’t have a transparent procedure for the election of directors, although this has been recognized as a principle of the code (A.7, SLCGC 2008). The absence of a nomination committee in the majority of companies in combination with low adherence to the recommended rules of the governance code, are explicitly evident from the survey results in respect to the appointment of directors. This raises doubts regarding the objective functioning of boards in Sri Lankan companies.

5.4.2.5 Performance Evaluation and a Code of Conduct for Directors

It is suggested that the board needs to have a formal procedure to evaluate both their own collective performance and that of individual directors (OECD, 2006). The SLCGC (2008) recognizes the importance of evaluating the board as a whole, and evaluating the CEO’s performance separately. It requires a CEO’s performance to be evaluated at least on an annual basis against a set target, given at the beginning of each financial year. However, individual director’s performance evaluation does not recognize as specific principles. The SLCGC (2008) provides a board evaluation checklist, given in Schedule B of the document, which recognizes various dimensions of performance evaluation including: the board as whole; board committees; and, executive and non-executive directors individually. Furthermore, the SLCGC (2008) requires company directors and senior management to adopt a ‘Code of Business Conduct and Ethics’ and for the company to disclose whether this code has been adhered to by its directors and senior management. Table 5.15 provides the criteria used in evaluating the performance of CEO and other directors. These criteria are taken directly from the Sri Lankan Corporate Governance Code (2008).

Table 5.15 summarizes the responses to questions about the performance evaluation of the CEO and other directors, and the application of a code of business conduct for directors. 58 per cent of the responding firms evaluate the performance of the CEO annually, whereas 50 per cent evaluate executive directors’ performance annually. However, by considering the existence of this practice alone it cannot be assessed how rigorous these evaluations are. To evaluate this aspect another question, whether the board has replaced the CEO during last five years, has been asked. 33 per cent of companies responded positively to this question. The question doesn’t specifically focus on whether these replacements were due to poor performance. In

some cases, CEOs could have taken better opportunities. When questioned about the CEO succession plan, only 68 per cent of the companies had a positive answer. This evidence suggests that the CEOs of Sri Lankan companies appear to be at a low risk of losing their job due to poor performance.

Table 5.15 Evaluation of CEO and other Directors

	Yes		No	
Characteristics	Number	%	Number	%
CEO and Executive Directors (EDs)				
– Board evaluates the CEO's performance annually	35	58	25	42
– Board evaluates the EDs' performance annually	30	50	30	50
– Succession plan for the CEO and the senior managers	41	68	19	32
– Board replaced the CEO during last 5 years	20	33	40	67
Non- Executive Directors (NEDs)				
– Board evaluates the NEDs' performance annually	14	23	46	77
– Retirement age for NEDs	28	47	32	53
– NEDs receive retirement pay	0	0	60	100
– NED(s) resigned due to a policy disagreement during last 3 years	0	0	60	100
– Chairman holds separate meetings for non-executive directors	16	27	44	73
– NEDs can obtain professional advice at the company expense	36	60	24	40
Code of Conduct				
– Firm has a written code of conduct & ethics for directors	26	43	34	57
– Written guidelines for directors' share dealings of the firm	34	57	26	43
– Members generally receive materials at least seven days prior to board meeting	52	87	8	13
– Firm provide training opportunities for newly appointed directors	23	38	37	62

With respect to the performance evaluation of NED's, only 23 per cent of the firms responded positively. 47 per cent of the companies prescribed a retirement age for the NED's. However, neither did they record a retirement pay, nor record an event of a NED resigning during the last three years due to a policy disagreement. Independence of the NED's is questioned in the sample, as only 27 per cent of the firms' chairmen conducted separate meetings for NEDs. Only 60 per cent of the sample firms allowed NED's to receive professional advice at their company's expense.

For independent directors to discharge their duties effectively as a board member, they should be provided with certain requirements. They should be able to hold separate discussions with the employees. Further, they should have access to documents such as financial records and their board's meeting agendas, and they should be provided with proper training at the company's expense. Once these requirements are fulfilled and once they are familiar with their role, it is assumed that the independent directors will have less chance of being manipulated by the CEO or a controlling shareholder. However, only 38 per cent of the responding companies provide such training to directors. 87 per cent provide materials to directors seven days prior to board meetings.

Only 43 per cent of the responding firms have a written 'Code of Conduct and Ethics' for directors. It is difficult to restrain insider dealings on the Sri Lankan share market, due to market anomalies and a lack of competent oversight by the Securities and Exchange Commission (SEC) of Sri Lanka, although it has the legal authority. Thus, it is important for companies to have written guidelines in respect of directors' share dealings. However, only 57 per cent of firms have written guidelines regarding share dealings of their directors with the company.

5.4.3 Directors' Remuneration

The area of executive remuneration is always controversial due to an agency conflict between managers and shareholders. The SLCGC (2008) states "companies should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual Directors" (principle B.1). It further requires companies to establish remuneration committees consisting exclusively of NEDs. The NEDs' remuneration should be determined by the board as a whole. However, companies are given flexibility in deciding levels of remuneration for both executive and non-executive directors. It requires at least part of executive directors' remuneration to be linked to corporate and individual performance (SLCGC, 2008).

Table 5.16 Directors' Remuneration

Characteristics	Yes		No	
	Number	%	Number	%
Remuneration Committee (RC)				
– RC exists	58	97	2	3
– Firm has written terms of reference governing the RC	39	67	19	33
– RC comprises a majority of independent directors	45	78	13	22
– RC is chaired by an independent director	47	81	11	19
– RC minutes are circulated among board members	40	69	18	31
– Dissents are recorded in the committee minutes	47	81	11	19
Remuneration policies and practices				
– Firm has written policies on directors' remuneration	30	50	30	50
– Board reviews CEO compensation annually	45	75	15	25
– Executive directors' remuneration (at least part) performance based	38	63	22	37
Share Options				
– Non-executive directors' remuneration includes share options	1	2	59	98
– CEO is given share options	8	13	52	87
Disclosure and Shareholder Approval				
– Performance based remuneration requires shareholders' approval	7	12	53	88

As per the requirements, the remuneration committee plays a major role in deciding the remuneration of executive directors and senior managers. It also deals with share options and performance based compensation policies. Table 5.16 provides the summarized information on the functions and composition of remuneration committees, remuneration policies and practices of respondent companies. The existence of remuneration committees in most of the companies (97 per cent) does not necessarily indicate the effectiveness of those committees. To be effective, a remuneration committee should be established formally with clear terms of reference. However, only 67 per cent of companies surveyed have written terms of reference, indicating potential inconsistent application of remuneration policies in some of the respondent companies. The fact that remuneration committees consist exclusively of NEDs does not necessarily indicate the independence of the committee. The independent directors' majority representation, and a committee chaired by an independent director however, are sound indicators of independence. 78 per cent of firms surveyed have a majority of independent directors on their remuneration committees, while 81 per cent of remuneration committees are chaired by an independent director. A high percentage of independent directors' involvement in remuneration committees is a good governance

practice adhered to by Sri Lankan companies. However, it is observed that about one fourth of the companies are not adhering to these practices. Furthermore, for the remuneration committees to be effective, committee minutes have to be maintained properly and circulated among all board members. However, only 69 per cent of the committees circulated minutes among members. Dissents are recorded in the remuneration committee minutes of 81 per cent of the companies surveyed.

The establishment of a remuneration committee prevents executive directors setting their own remuneration packages. The remuneration committee is also responsible for implementing formal and transparent procedures for setting executives' remuneration, including appropriate targets for performance based compensation. Making recommendations on remuneration policies, and reviewing CEO's and other executives' remuneration are important tasks of the committee. However, despite having remuneration committees in 97 per cent of the companies surveyed, only 50 per cent of these companies have written policies on directors' remuneration. This shows divergence from best practice of the remuneration committees for these companies. The proportion of executive directors' remuneration is not attached to performance for 37 per cent of the companies surveyed. This indicates performance, either by the company or the individual, is not a limiting factor for directors to receive regular remuneration. Further, survey evidence shows that even if the companies have a performance based remuneration component, 88 per cent of these companies do not require shareholders' approval for these remuneration recommendations.

One of the tasks of the board is to review the compensation of the CEO. 75 per cent of the responding firms undertake this task. Only 13 per cent of Sri Lankan firms compensate their CEO using stock options, suggesting that share market performance is not a deciding factor for CEOs to secure their remuneration. As the directors and CEOs are not at risk of losing their remuneration for poor firm performance, there may not be satisfactory motivation for them to perform in the interests of their shareholders. This could have a negative impact on firm performance, leaving shareholders at risk.

5.4.4 Audit committee procedure

The audit committee (AC) is arguably the most important of the board sub-committees and therefore governance codes contain extensive requirements for audit

committees. The SLCGC (2008) requires companies to set up audit committees on the grounds that "the board should establish formal and transparent arrangements for considering how they should select and apply accounting policies, financial reporting and internal control principles and maintaining an appropriate relationship with the Company's Auditors" (Principle D.3). Thus an audit committee is required to assist the board over matters such as accounting and financial statements, compliance with regulations, internal control, going concern assessment and external auditor's independence and performance. As per SLCGC (2008), an audit committee should have written terms of reference indicating the purpose, duties, and responsibilities of the committee. Further, it requires an audit committee to have two independent NEDs or exclusively NEDs with a majority of independent directors.

Table 5.17 Audit Committee Structure and Practices

	Yes		No	
Characteristics	Number	%	Number	%
Existence and membership				
– Audit committee exists	60	100	-	-
– AC includes someone with expertise in accounting	57	97	2	3
– AC comprises of exclusively non-executive directors	47	80	12	20
– AC has majority of independent directors	52	88	7	12
– AC is chaired by an independent director	54	92	5	8
Powers and processes				
– Firm has written terms of reference governing audit committee	54	92	5	8
– AC minutes are circulated among board members	45	76	14	24
– AC recommends the external auditor to full board	51	86	8	14
– Minority shareholders can elect an AC member	8	14	51	86
– Hold meetings with the external auditor	52	88	7	12
– Members are paid a fee or allowance for serving on the committee	45	76	14	23

Effectiveness of the AC depends upon the composition of the committee, and its processes. Composition concerns: the number of independent directors'; having accounting and finance professionals on the committee; and, having an independent chairman. Processes deal with: the role of selecting auditors and maintaining a working relationship with them; procedures regarding minutes; remuneration of committee members; and, written terms of reference for committee proceedings. The analysis of this study's survey results concerning the practices of Sri Lankan companies' audit committees are summarized in Table 5.17. As to the independence of the members of

audit committees, 92 per cent of the firms surveyed were chaired by an independent director, while 88 per cent of the firms had committees comprising a majority of independent directors, out of which 80 per cent were exclusively comprised of independent directors. The survey results further show that 97 per cent of the firms had an accounting professional on the committee. A relatively high compliance is observed in relation to the best governance practices of audit committees in comparison to the practices of nomination and remuneration committees. However, 20 per cent of the companies surveyed have not complied with the practice of having a composition of exclusively NEDs on the audit committee. This is a major drawback as far as independence of the committee is concerned.

Focusing on the processes of the audit committees, one can see that committees of 92 per cent of the responding firms had written terms of reference, 76 per cent circulated audit committee minutes among members, 86 per cent recommended the appointing of external auditors to the board, 88 per cent held meetings with the auditors, and 76 per cent paid a fee to their members for holding office. This evidence further suggests that the majority of audit committees of Sri Lankan companies are functioning actively and carrying out their duties properly.

5.4.5 Disclosure and transparency

Disclosure of information plays a major role in corporate governance, as it is the means of conveying to the public how effectively management discharges their duties to shareholders. Confidence of the public can be gained only if such information is disclosed in a manner which ensures transparency, usefulness and understandability. *The Cadbury Report* (1992) recognizes that the foundation of any structure of corporate governance is disclosure. Iskander and Chamlou (2000) claim that openness is the basis of public confidence in the corporate governance system. The SLCGC (2008) requires boards to ‘present a balanced and understandable assessment of the company's position and prospects’ (Principle D.1). Further, it states that the board is responsible for submission of interim reports and all price sensitive information to the shareholders. Principle C.2 of SLCGC (2008) requires disclosing all proposed major transactions to shareholders. In this respect the board is responsible for disclosing all facts of all transactions which would materially affect net assets of the company. *The Cadbury Report* (1992) also states that boards should aim for the highest level of disclosure

without compromising the competitive position of the company. It further recognizes the importance of disclosing fees paid to audit firms for non-audit work, directors' total emoluments, and the emolument of the highest paid director including stock options. Due to these requirements, the items for which information must be disclosed have recently been expanded significantly. Companies are required to disclose much more detailed information than in the past about related-party transactions.

Table 5.18 Disclosure and Transparency

	Yes		No	
Disclosures on the Company Website	**Number**	**%**	**Number**	**%**
– Quarterly financial statements	33	55	27	45
– Audited Annual reports	37	62	23	38
– Directors' report	34	57	26	43
– Directors' selling or buying shares in the firm (if any)	14	23	46	77
–				
– Related-party transactions (if any)	9	15	51	85
– Resume or background of directors	12	20	48	80
– Individual remuneration of directors	4	7	56	93
– Policies on risk management	7	12	53	88
– Corporate governance report	7	12	53	88
– Separate disclosure of audit and non-audit fees paid	8	13	52	87
– Members of board sub committees	7	12	53	88
– Audit committee report	6	10	54	90
– Remuneration committee report	7	12	53	88
– Nomination committee report	4	15	23	85
Disclosures on the Annual Reports				
– Related-party transactions (if any)	59	98	1	2
– Resume or background of directors	60	100	0	0
– Individual remuneration of directors	17	28	43	72
– Policies on risk management	49	82	11	18
– Corporate governance report	60	100	0	0
– Separate disclosure of audit and non-audit fees paid	51	85	9	15
– Members of board sub committees	58	97	2	3
– Audit committee report	54	90	6	10
– Remuneration committee report	44	73	16	27
– Nomination committee report	18	67	9	33

Table 5.18 summarizes the responses to survey questions regarding whether companies provide different types of information on their websites, as well as separately in their annual reports. Information was obtained from surveyed companies' websites.

Table 5.18 highlights the type of information disclosed on company websites for the sample firms. The analysis of survey responses shows that over 60 per cent of the firms surveyed disclose financial information (both annual and quarterly) on their company website. Also 57 per cent disclose their Directors' Report on the web. However, only 23 per cent of the companies surveyed disclose their directors' share transaction information. Despite the fact that the board is responsible for disclosing all price sensitive information including major transactions and important reports, this information is not adequately disclosed by Sri Lankan companies on their websites. Less than 20 per cent of the firms disclosed important price sensitive information such as: related party transactions; the resume or background of directors; directors' remuneration; policies on risk management; audit and non-audit fees; memberships of sub committees; and, committee reports, indicating a lack of transparency for most of the Sri Lankan companies surveyed.

Apart from the audited financial statements, companies are required to publish information on related party transactions, the resumes and remuneration of directors, corporate governance reports, and committee reports etc. in their annual reports. According to the data of the responding firms, most of the required information is available in their annual reports. Every firm in the sample has disclosed the resume or background of their directors and a corporate governance report in their annual report. Related party transactions are declared by 98 per cent of the firms in the annual report. More than 80 per cent of the companies have declared policies on risk management and the quantum of audit and non-audit fees paid. Memberships of boards' sub-committees are declared by 97 per cent of the sample. Disclosure of the reports of the audit, remuneration and nomination committees are made by 90 per cent, 73 per cent and 67 per cent of the companies respectively. However, only 28 per cent of the firms give information on directors' remuneration, which is the lowest level of disclosure. It is interesting to note that lower levels of disclosure are observed in relation to directors' remuneration (23 per cent), remuneration committees' reports (73 per cent), and nomination committees reports (67 per cent). As this information relates to lower levels of disclosure for directors' remuneration and appointment, it can be argued that an agency conflict is one of the major issues in Sri Lankan companies. Sri Lanka experienced a series of finance company failures in the late 1990s, and the breakdown of major groups of companies including financial institutions in 2009, largely due to

high incidents of fraud committed by company directors. Lack of disclosure has a negative effect on corporate governance practices (Susilowati et al. 2005). Focus on more disclosure, specifically on price sensitive information and information directly related to directors' affairs, should be given priority by policy makers.

5.4.6 Disclosure reliability

The quality and the reliability of financial disclosures are largely influenced by the review and the assurance that is provided by external auditors, and reliance upon their independence. The external auditor provides both audit and non-audit services. As non-audit services can have a negative impact on the independence of the auditor, the survey focuses on audit committees' contributions to maintaining high quality work by external auditors, and other measures implemented by the firm to protect the quality and independence of external auditors.

Tables 5.19 and 5.20 indicate the quantum of auditors' independence and the non-audit fees paid to the auditor. 58 per cent of the firms obtained non-audit services. 68 per cent of the companies rotate the audit partner once every five years. A review of the auditor's work by the audit committee is carried out by 88 per cent of firms. The review of audit recommendations by the entire board is followed by more than 80 per cent of the responding firms. 48 per cent of the firms who obtained non-audit services limited their non-audit service fees to less than 20 per cent of the audit fees. However, 31 per cent of the firms had non-audit fees of 21 per cent to 50 per cent of audit fees, while 20 per cent of the firms paid non-audit fees over 50 per cent of the audit fee. This evidence suggests that most of the auditors who provide non-audit services are dependent on the non-audit assignment, which could have a negative effect on their independence, and the perception of their independence.

Table 5.19 External Auditor

	Yes		No	
Characteristics	Number	%	Number	%
– Audit committee conducts formal reviews of the auditor's work	53	88	7	12
– Audit partner rotation every 5 years	41	68	19	32
– Audit recommendations are subject to full board review	57	95	3	5
– Auditor provides non-audit services to your firm	35	58	25	42

Table 5.20 Auditor's Involvement in Non-audit Assignment

Non-audit Fee as a Percentage of Total Audit Fee	Frequency	Per cent
Less than 20%	17	48
21% - 50%	11	31
Over 50%	7	20
Not Applicable	25	-
	60	**100**

5.4.7 Shareholders' Rights

From an agency theory perspective shareholders are viewed as the principal, and the objective of management is to maximize the interests of shareholders. Agency theory argues that managers are focused on self-interest rather than on the interests of owners. This suggests that ownership and managerial interest are not aligned, leading to agency costs and internal inefficiencies. Due to the existence of such agency costs and internal inefficiencies, agency theory argues that one of the purposes of the corporate governance mechanism is to provide shareholders with assurance that managers achieve outcomes that are in the shareholders' interests (Jensen and Meckling, 1976). Thus, there should be adequate provisions in governance codes to protect the shareholders' rights.

Shareholders should be given rights and opportunities to participate directly in monitoring their firms. Their basic rights include: obtaining relevant corporate information on a timely and regular basis; participating in and voting at general shareholders' meetings; and, electing board members (OECD 2004). Even if shareholders cannot physically attend meetings, they should be able to participate in decision making through designating proxies or voting by mail. The shareholders should be provided with adequate information about agenda items and be encouraged to ask questions, make comments, and raise issues at meetings. Thus the length of shareholders' meetings and the number of shareholders in attendance might yield information about the effectiveness of shareholders' meetings.

The SLCGC (2008) requires the board to use the Annual General Meeting (AGM) to communicate with investors and encourage their participation (Principle C.1). Further it states that all proxy votes should be counted and separate resolutions should be in force for substantial issues and the adoption of accounts. The chairpersons of sub-committees are required to be present at the AGM to respond to questions raised by

shareholders. Individual investors are encouraged to participate in AGMs and exercise their voting rights. Companies are required to send notice of AGMs and related papers to shareholders before the meeting and circulate a summary of the procedures governing voting at General Meetings (SLCGC, 2008; Principles C.1.1 – 1.5). Many Asian countries have introduced a range of provisions to protect shareholders' rights, especially after the economic crisis (Nam and Nam, 2004). This survey is concerned with whether in the Sri Lankan context there is effective participation in decision making, with the election of directors, and the upholding of other shareholders' rights. The summarized results of the survey are given in Table 5.21.

Table 5.21 Shareholders' Rights

	Yes		No	
Characteristics	Number	%	Number	%
– Voting by mail is allowed	17	28	43	72
– Anybody can serve as a proxy	58	97	2	3
– Shareholders requested an extraordinary meeting in last 3 years	6	10	54	90
– Firm discloses director candidates to shareholders prior to AGM	43	72	17	28
– Chairpersons of sub-committees are always available at the AGM	57	95	3	5
– Adequate time is given for asking questions at the AGM	60	100	0	0
– Shareholders' priority subscription rights are adequately protected	44	73	16	27
– Related-party transactions fully disclosed at the AGM	58	97	2	3
– Firm does not deviate from the one-share one-vote rule	54	90	6	10
–				

All of the responding firms allow adequate time to shareholders to ask questions at the AGM. This appears to be a sound governance practice in ensuring the protection of non-controlling shareholders' rights. However, as appears in Table 5.22, the average duration of the AGM of 65 per cent of the firms surveyed is less than one hour. 28 per cent of the firms had an AGM lasting for one to two hours, and none of the firms had an AGM of over three hours. Duration of the AGM is important since the shareholders need adequate time to raise issues, discuss matters, and make comments etc. The limited time duration of the meetings suggests that AGMs of Sri Lankan firms are largely inactive. This fact can be corroborated by analysing the voting behaviour of the AGM. For example, the average voting rights exercised at the AGM for 30 per cent of the companies is less than 10 per cent, suggesting low priority given by shareholders for AGM activities.

Table 5.22 Duration and Voting Performance of the AGM

Average duration of the AGM	Frequency	Percent
Less than 1 hour	39	65
1-2 hours	17	28
2-3 hours	4	7
Over 3 hours	0	0
Average Percentage of Voting Rights Exercise at AGM		
Less than 10%	18	30
10% - 40%	6	10
40% - 60%	10	17
60% - 80%	7	12
80% - 100%	19	32

One of the fundamental rights of a shareholder is voting. Even though shareholders are unable to present themselves at meetings, they can be represented by allowing them to vote by mail, or by designating proxies to vote on their behalf. A high percentage of firms surveyed (97 per cent) allow anybody to serve as a proxy. However, only 28 per cent of the companies allow voting by mail. When analysing the voting rights exercised at the AGMs of companies surveyed, it is noted that shareholders of one third of firms surveyed exercise their voting rights less than 10 per cent of the time. On average 10 per cent of companies voting at AGM varies among 10 per cent to 40 per cent. Only 30 per cent of companies have shareholder voting participation above 80 per cent. Given that most firms have controlling shareholders with a high concentration of ownership, the fraction of shareholders exercising their voting rights at the AGM is surprisingly small. For example, as shown in Table 5.5, 65 per cent of the respondent companies have over 80 per cent share ownership concentrated in the first 10 largest shareholders. It further shows that over 64 per cent of the companies have over 40 per cent of ownership concentration with their largest shareholder. The voting behaviour and length of the AGM suggests that non-controlling shareholders often do not participate and vote in AGM activities. The restriction on voting by mail undermines the rights of shareholders and could have aggravated the low voting rights exercised at the AGM.

In 95 per cent of the firms, chairpersons of sub committees are available at the AGM. 72 per cent of the firms did a prior AGM declaration of the director candidates, while 97 per cent of the firms fully disclosed their related party transactions at the

AGM. However, shareholders of one tenth of the firms requested extra-ordinary meetings in the last three years. This possibly is a sign of conflict between shareholders and the management of these companies. Sri Lanka is among the many Asian countries which experience frequent controlling shareholder activities in the share market. The proportion of share ownership of non-controlling shareholders should be protected in new share issues by securing pre-emptive rights. However, 27 per cent of the companies have not protected priority subscription rights of their shareholders.

5.4.8 Related Party Transactions

As discussed in the preceding sections, one of the problems of corporate governance in Sri Lanka is the presence of dominant shareholders who control a group of companies, and who are instrumental in many inappropriate actions in corporate governance. Nam and Nam (2004) state that one of the main reasons for the Asian crisis in 1997 related to corporate governance issues. They claim that "the most salient feature of the corporate governance problems of the East Asian countries is the presence of dominant shareholders who control a group of firms and who were behind many of the illegal or inappropriate actions of managers that resulted in asset dissipation, expropriation of minority shareholders, and lack of transparency in information disclosure before 1997" (Nam and Nam, 2004, p.27). However, irrespective of the evident presence of dominant shareholders in Sri Lankan companies, the SLCGC (2004) has not given adequate attention to related party transactions (RPTs) and the best governance practices relating to them.

Having recognized the importance of exploring the nature and intensity of RPTs in Sri Lankan companies, this survey is carried out based on OECD principles. OECD principles (2004) require boards to monitor and manage potential conflicts of interest of management, board members and shareholders, including abuse in related party transactions. Non-controlling shareholders should be protected from abusive actions by controlling shareholders. The OECD principles (2004) state the abuses may be carried out in various ways. These include: extraction of direct private benefits; inappropriate RPTs; systematic bias in business decisions; and, changes in capital structure through special issuance of shares favouring the controlling shareholder. In this respect, boards should take the initiative by assigning a sufficient number of NEDs capable of exercising independent judgment to the tasks where there is a potential conflict of

interest. Furthermore, it is essential for any company to fully disclose material RPTs to the market, including whether they have been executed at ‘arms-length’ terms. Related parties can include entities that are under common control with the company, significant shareholders including members of their families, and key management personnel. A transaction with someone who has a close and privileged relationship with companies such as controlling owners, directors, members in senior management and their immediate family members and other affiliated companies that they control is recognized as a RPT in this survey.

Table 5.23 Related Party Transactions

Characteristics	Yes		No	
	Number	%	Number	%
Firm discloses RPT(s) to shareholders	60	100	0	0
Firm requires RPT(s) to be at arm's-length terms	53	88	7	12
Firm has outstanding loan(s) to insider(s)	10	17	50	83
Firm carryout sales and purchases from insiders	13	22	47	78
Firm rent or lease real property to or from insider(s)	13	22	47	78
Board reviewed the RPT(s) last year	49	82	11	18

Information on RPTs is provided in Table 5.23. All the firms of the sample disclose RPTs to the shareholders as this is required by Sri Lanka’s *Accounting Standards* and *Companies Act (2007)*. However, as indicated in Table 5.18, only 15 per cent of companies disclose RPTs on their websites. This suggests that the companies are reluctant to disclose RPTs voluntarily. As most Sri Lankan companies have a controlling shareholder, it is important to carry out RPTs at arm’s-length terms. However, only 88 per cent of the companies surveyed require RPTs to be at arm’s-length terms. Another measure of significance of RPTs is how many firms reported a board review of RPTs. The majority of respondents (82 per cent) report that their boards have reviewed the RPT’s of the previous year. A full board review of RPTs is a good practice, but less good news is that there are a number of significant RPTs carried out by the majority of companies surveyed. The analysis of the nature of RPTs reveals that 17 per cent of the firms have outstanding loans, 22 per cent carry out sales and purchases transactions, and 22 per cent rent or lease real property with insiders. The magnitude of transactions is also important in deciding the rigorousness of RPTs. As shown in Table 5.24, nearly 50 per cent of the firms reported that the value of their

RPTs is less than one per cent of the total revenue. However, 12 per cent of the companies reported that the values of RPTs are over 10 per cent of total revenue.

Table 5.24 Magnitude of the RPTs

Value of RPTs as a Percentage of Total Revenue	Frequency	Percent
Less than 1%	25	42
1% - 5%	13	22
5% - 10%	1	2
Over 10%	7	12
Not Applicable	14	23
	60	100

Table 5.25 Required Level of Approval for RPTs

Required Approval Level	RPTs with executives		RPTs with controlling shareholders	
	Frequency	Percent	Frequency	Percent
– Approval by the shareholders	0	0	0	0
– Approval by the non-conflicted directors or audit committee	2	3	3	5
– Approval by the board	26	43	32	53
– Approval by the CEO	21	35	9	15
– Approval by the CFO	2	3	0	0
– No approval required	9	15	10	17
– Not Applicable	-	-	6	10
	60	100	60	100

Table 5.25 shows the summarized responses relevant to approval levels of RPT's separately for company executives and shareholders. In both cases, none of the companies require shareholder approval for RPTs. Furthermore, only three per cent and five per cent of companies require approval from the non-conflicted directors or audit committee to execute RPTs with executives and controlling shareholders respectively. Over 15 per cent of the respondent companies state that they do not require specific approval to carry out RPTs with either an executive or controlling shareholders. This creates serious doubts over required levels of independence in carrying out RPTs in Sri Lankan companies.

The majority of companies require only board approval. For example, this is 43 per cent in the case of executives and 53 per cent relating to controlling shareholders. At the next level only CEO approval is enough to perform RPTs with executives and

controlling shareholders for 35 per cent and 15 per cent of the companies respectively. In three per cent of the firms, approval for RPTs with executives has been granted by the CFO. The diverse practices adopted by Sri Lankan companies, especially with regard to required approval levels for RPTs, indicate dominant shareholders' influence on the affairs of Sri Lankan companies. Furthermore, the problem of not having enough provisions in the SLCGC, especially in relation to required levels of approval for the execution of RPTs is clearly evident. The lack of independence of the boards and the existence of controlling shareholder(s) as observed in preceding sections aggravates the negative effects of RPTs on non-controlling shareholders. Thus, these factors should be given more attention by policy makers in developing best governance practices for RPTs.

5.5 Evaluation of Level of Compliance of Corporate Governance Practices

The level of corporate governance of sample companies is examined by developing a *Corporate Governance Index* (CGI) in achieving the third objective of the study. As specified in Section 4.5.3 the scores of the CGI and sub-indices are analysed based on a number of methods. The subsequent sections present the results of these analyses. Analysis results of the overall governance score distribution and descriptive statistics of the overall index and sub-indices are given in Section 5.5.1. As the compliance to governance practices can significantly vary across the nature of family ownership and foreign ownership, and the existence of controlling shareholder(s), the level of compliance is analysed across sub-samples. The analysis results of the comparison of sub-indices across sub samples, and the comparison of individual items of CGI across sub samples are given in Section 5.5.2. Section 5.5.3 presents the impact of ownership on compliance to corporate governance practices for the whole sample across each sub index. As indicated in Section 4.5.3 the analysis of the index score is carried out with eight sub-indices representing different dimensions of governance. The maximum possible scores for each sub-index depend on the number of governance practices examined in the respective sub-index. The sub-indices with maximum possible scores are given below.

Board Structure & Independence (BSI) - 07
Board Procedure and Effectiveness (BPE) - 25
Audit Committee Procedure (ACP) - 10
Directors' Remuneration Procedure (DRP) - 08

Disclosure Substance (DS) - 15
Disclosure Reliability (DR) - 05
Shareholders' Rights (SR) - 12
Related Party Transactions (RPTs) - 08

The maximum possible score for overall Corporate Governance Index (CGI) is 90, which is the addition of maximum marks of its eight sub indices.

5.5.1 Frequency Distribution Analysis of Governance Scores

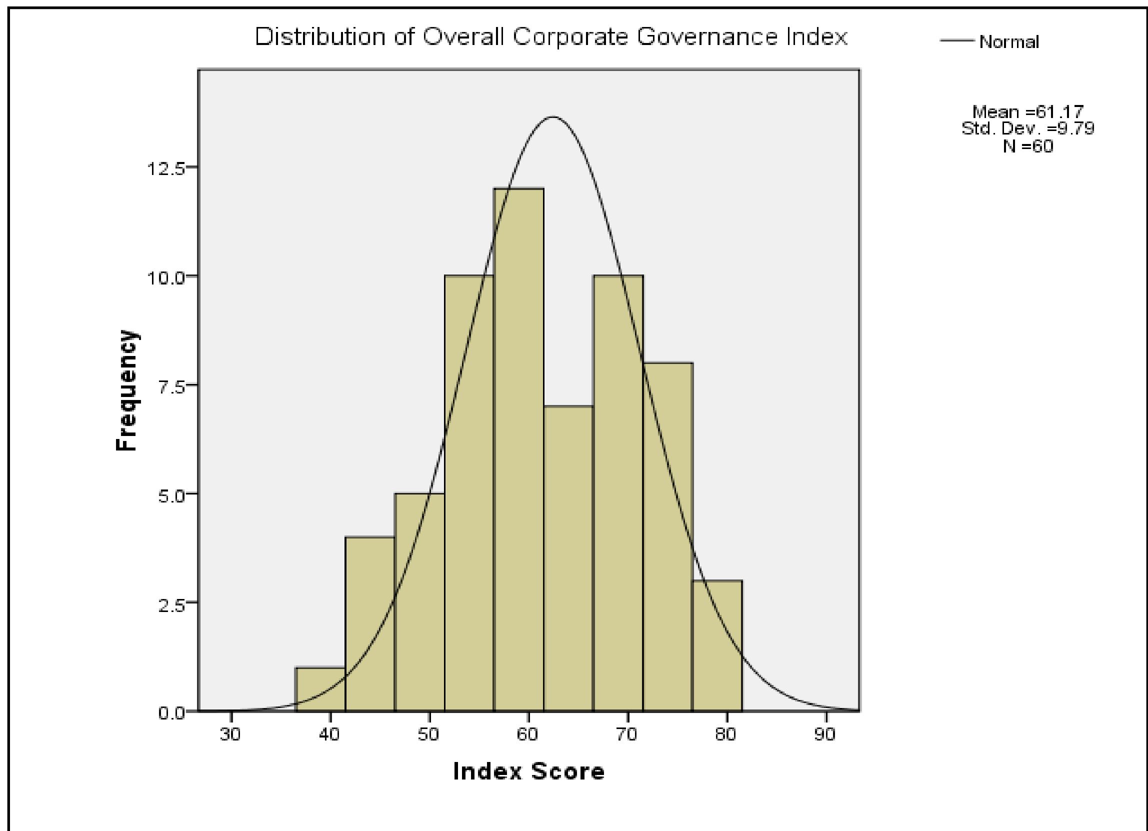
When sample companies are distributed based on the overall CGI as shown in Table 5.26, none of the companies have obtained an average score of 90 per cent or more. However, the majority of companies have better compliance to Audit Committee Procedure (ACP), Shareholders Rights (SR) and Directors' Remuneration Procedure (DR) dimensions. The ACP sub-index shows that over 33 per cent of the companies obtained an index score of over 90 per cent. Furthermore, 33 per cent and 28 per cent of companies obtained an average score of over 90 per cent for DR and SR sub-indices respectively. This evidence shows the practices relating to audit committee procedure, shareholders' rights, and disclosure reliability. Out of the other dimensions, over 30 per cent of the companies have obtained an average score of less than 50 per cent for RPTs and Board Procedure and Effectiveness (BPE) sub-indices. The RPTs and BPE are the worst performed dimensions of overall corporate governance practices.

Table 5.26 Frequency (%) Distribution of Corporate Governance Scores

Index Score (%)	Sub-indices								Overall Index
	BSI	BPE	ACP	DRP	DS	DR	SR	RPTs	
≥0%< 20%	2%	-	2%	2%	-	-	-	-	-
≥ 20%< 30%	2%	10%	-	2%	2%	-	-	3%	-
≥ 30%< 40%	-	15%	3%	5%	12%	3%	-	8%	-
≥ 40%< 50%	17%	10%	-	10%	3%	-	3%	30%	7%
≥ 50%< 60%	25%	25%	2%	-	18%	20%	3%	-	17%
≥ 60%≤ 70%	-	7%	13%	35%	18%	-	12%	40%	35%
≥ 70%≤ 80%	37%	15%	18%	18%	33%	43%	27%	17%	32%
≥ 80%< 90%	17%	17%	28%	27%	8%	-	27%	2%	10%
≥ 90%≤100%	2%	2%	33%	2%	5%	33%	28%	-	-

Note: BSI - Board Structure & Independence; BPE - Board Procedure and Effectiveness; ACP - Audit Committee Procedure; DRP - Directors' Remuneration Procedure; DS - Disclosure Substance; DR - Disclosure Reliability; SR - Shareholders' Rights; RPTs - Related Party Transactions

Figure 5-1 Distributions of Overall Corporate Governance Index Scores



The histogram (Figure 5.1) shows the fraction of firms with overall CGI scores in indicated ranges. The histogram with a mean value of 61.17 (68 per cent) and standard deviation of 9.79 shows the overall CGI is normally distributed. As shown in Table 5.27, the results of the Shapiro-Wilk Test also confirm that the overall CGI is normally distributed. If the significant (Sig.) value of Shapiro-Wilk Test is greater than 0.05 then the data is normal. The Sig. value of 0.563 for overall CGI confirms that the overall index is normally distributed, indicating reasonable distribution is available in respect of high compliance and low compliance companies within the sample. However, none of the sub-indices is normally distributed, as indicated by the significant value of the Shapiro-Wilk test which is lower than 0.05 for all the sub-indices.

Table 5.27 provides further data on the overall CGI and its sub-indices. There is substantial spread on each of the sub-indexes, and for the CGI as a whole. As shown in the descriptive statistics, the sub-indices indicate substantial variations of compliance to governance practices by Sri Lankan companies. The mean values (%) of ACP, DR and SR sub-indices are over 80 per cent, but all these sub-indices also indicate high

variations of application of governance practices, as shown in the minimum and maximum values. This indicates that despite high levels of compliance by most of the companies, a minority group of companies comply less with these practices. Furthermore, a substantial range is shown between the minimum and maximum values of other sub-indices. This behaviour raises a question as to whether there are dominating factors which determine compliance to governance practices by Sri Lankan companies. Thus, it warrants further analysis of data to find out whether the existence of family or foreign ownership, and the presence of a controlling shareholder have created diverse impacts on governance practices in Sri Lankan companies.

Table 5.27 Descriptive Statistics for Governance Index Variables

	Mean	Mean %	Std. Devi.	Mini	Max	Max Possible	Skewness	Shapiro-Wilk	Sig.
BSI	4.48	64%	1.214	0	7	7	-.841	.902	.000
BPE	14.53	58%	4.908	6	23	25	.061	.952	.020
ACP	8.53	85%	1.712	1	10	10	-2.082	.770	.000
DRP	5.43	68%	1.454	0	8	8	-1.044	.887	.000
DS	9.93	66%	2.517	4	15	15	-.397	.960	.045
DR	4.07	81%	.821	2	5	5	-.506	.838	.000
RPTs	4.63	58%	1.025	2	7	8	-.374	.911	.000
SR	9.55	80%	1.294	6	11	12	-.793	.881	.000
Overall Index	61.17	68%	9.790	39	80	90	-.169	.983	.563

5.5.2 Comparative Analysis of Corporate Governance Scores of Sub Samples

This section deals with the comparative analysis of corporate governance scores for six sub samples across three dimensions of ownership namely: family ownership; foreign ownership; and, controlling shareholder's ownership. The comparisons of sub samples in each ownership dimension are: Family Based (FB) vs. Non Family Based (NFB); Less (or no) Foreign Owned (LFO) vs. Substantially Foreign Owned (SFO); and, presence of Controlling Shareholders (CSs) vs. absence of CSs. (refer Section 5.3.3 for details). The comparative analysis of governance scores across the overall CGI and the sub-indices is carried out in the first part of this section. The comparison is carried out in order to identify the compliance differences across each sub index and the overall CGI. In the second part, the scores of individual variables (classified under eight sub-

indices) are analysed to obtain a comprehensive view of the level of compliance across each sub sample in respect of governance practices.

5.5.2.1 Comparative Analysis of Index Scores across Sub Samples

As shown in Table 5.28, the level of compliance to best corporate governance practices by FB companies is relatively low across all governance dimensions measured in the sub-indices. Accordingly, the overall index score for FB companies is 55 (62 per cent) as against the score of 65 (72 per cent) for NFB companies. This evidence suggests that family ownership has a significant negative impact on compliance to corporate governance practices in Sri Lankan companies. In their on corporate governance in Asia, Nam and Nam (2004) claim that the family controlled businesses have been inadequately supervised by outside shareholders, boards of directors, or markets for corporate control. As a result these companies have experienced inadequate accounting disclosures and lack of transparency. Furthermore, they claim that the controlling family owners have been able to pursue their private interests relatively easily, often at the expense of non-controlling shareholders. In conformity with this finding, the survey results appearing in Table 5.28 show that FB companies have significantly lower levels of scores for BPE, ACP and DS sub indices. This suggests that Sri Lankan family owned companies also experience similar behaviour in respect of board procedure practices, audit committee procedures, and financial disclosures.

Corporate governance appears to be better in companies that are SFO. In contrast to family ownership, substantial foreign ownership constantly has a positive impact on compliance to corporate governance best practices across the eight dimensions considered in this survey. Specifically, more effective boards of directors are observed in respect of these companies. Out of six sub samples, SFO companies have the highest score (76 per cent) for the overall CGI. This indicates compliance to governance practices is positively influenced by the presence of foreign owners. High compliance is likely to influence the internal governance structure of these companies, and the governance code development process in Sri Lanka. Foreign owners generally demand a higher quality of corporate governance due to pressure from parent companies. This is likely to produce high compliance to best governance practices. Furthermore, as the *Sri Lankan Governance Code* (2008) is developed based on OECD (2004) principles and the governance codes developed in the western countries, the

companies which characterize companies operating in the Anglo-Saxon model are more likely to be compliant with the Code. As such, SFO firms are likely to be able to comply with the governance practices with ease. Given this behaviour, applicability of the Code for the majority of Sri Lankan companies needs to be investigated more closely.

Table 5.28 Comparison of Index Scores across Sub Samples

Sub-Index	Max Possible	Overall	Family Ownership		Foreign Ownership		Controlling Owners	
			FB	NFB	LFO	SFO	Yes	No
Board Structure and Independence	7	4.48 (64%)	4.30 (61%)	4.59 (66%)	4.38 (63%)	4.85 (69%)	4.35 (62%)	4.82 (69%)
Board Procedure and Effectiveness	25	14.53 (58%)	12.22 (49%)	15.97 (64%)	13.62 (54%)	17.85 (71%)	14.05 (56%)	15.76 (63%)
Audit Committee Procedure	10	8.53 (85%)	7.83 (78%)	8.97 (90%)	8.30 (83%)	9.38 (94%)	8.56 (86%)	9.00 (90%)
Directors' Remuneration Proce.	8	5.43 (68%)	4.91 (61%)	5.76 (72%)	5.30 (66%)	5.92 (74%)	5.40 (67%)	5.53 (69%)
Disclosure Substance	15	9.93 (66%)	8.65 (58%)	10.73 (72%)	9.62 (64%)	11.08 (74%)	9.67 (64%)	10.59 (71%)
Disclosure Reliability	5	4.07 (81%)	4.04 (81%)	4.08 (82%)	4.00 (80%)	4.31 (86%)	4.07 (81%)	4.06 (81%)
Related Party Transactions	8	4.63 (58%)	4.39 (55%)	4.78 (60%)	4.62 (58%)	4.69 (59%)	4.44 (56%)	5.12 (64%)
Shareholders' Rights	12	9.55 (80%)	9.35 (78%)	9.68 (81%)	9.45 (79%)	9.92 (83%)	9.49 (79%)	9.71 (81%)
Overall Index Scores	**90**	**61.17 (68%)**	**55.70 (62%)**	**64.57 (72%)**	**59.28 (66%)**	**68.00 (76%)**	**60.02 (67%)**	**64.59 (72%)**

Note: FB – Family Based Companies; NFB – Non Family Based Companies;
LFO – Less Foreign owned companies; SFO – Substantially Foreign Owned companies

The presence of controlling shareholders is a common occurrence for most of the Sri Lankan companies surveyed. As shown in Table 5.28, the presence of controlling shareholders has a negative effect on firm compliance to corporate governance practices. The comparative scores of the sub indices show relatively low compliance across all dimensions is experienced by companies in which management decisions are dominated by the controlling shareholders. Many empirical studies show that firms with controlling shareholders tend to perform better, because they have a strong incentive to closely monitor their firms (Jensen and Meckling 1976; Shleifer and

Vishny 1986). However, beneficial effects of controlling shareholders should be expected only when management is separated from ownership, or when proper corporate governance mechanisms are in place within the companies. These conditions are generally not met in most Asian companies (Nam and Nam 2004). As in many other emerging markets in Asia, the ownership of Sri Lankan companies is highly concentrated with a presence of controlling owners. Furthermore, they are typically preoccupied with conducting the managerial function themselves due to the perceived agency problem. Thus, the presence of controlling shareholders can have negative effects on many dimensions of corporate governance, as evident from the scores of sub indices across all dimensions of corporate governance examined in this study. In most Asian countries, directors are handpicked by controlling shareholders, and are used to dominate boards and thus controlling shareholders are able to force managers to enter into transactions that are beneficial to them (Nam and Nam 2004). Consistent with these claims, the lowest level of compliance is observed in respect of board procedure and related party transactions, as shown in an index score of 56 per cent.

The comparative analysis of corporate governance scores of the six sub samples across three ownership dimensions provide prima facie evidence that there is a relationship between ownership and corporate governance of companies. The level of corporate governance of family owned companies is lower than that of non family owned companies, indicating a negative impact on the level of corporate governance. However, foreign ownership has created a positive influence on all dimensions of corporate governance examined in this study. The presence of controlling shareholders has created negative impacts on corporate governance.

5.5.2.2 A Comparative Analysis of Corporate Governance Practices across Ownership Dimensions

The results of a comparative analysis of sub indices' scores across three ownership dimensions (refer Section 5.5.2.1) provide prima facie evidence that there is a relationship between corporate ownership and corporate governance practices in Sri Lanka. The results suggest that family ownership has a negative influence on governance practices, whereas foreign ownership has a positive influence on governance practices. Further, it shows that the presence of a controlling shareholder is a negative influence on corporate governance practices. However, how individual practices have contributed to this behaviour is not evident from this analysis. Thus,

further analysis is required to diagnose the level of compliance of individual practices in each corporate governance dimension. In this section, individual governance practices are comparatively analysed within each dimension of ownership, in order to obtain a comprehensive view of the level of compliance and the impact of ownership type on individual corporate governance practices.

a) **Board Structure and Board Independence (BSI)**

Family Ownership and Compliance to BSI Practices:

The level of compliance of FB with best corporate governance practices in respect of board structure and board independence is lower than that of NFB. However, there are different compliance levels observed with regard to individual governance practices. The level of compliance of FB companies is significantly lower than that of NFB companies in respect of: having at least 50% of NED's on the board; appointing independent directors; selection of NEDs by the board or nomination committee; and, meetings of NEDs without executive directors to discuss firm affairs (refer items 1, 2, 6 and 7; Table 5.29). These practices have contributed towards the lower BSI index score of FB companies compared to that of NFB companies. The level of compliance of both NFB and FB companies is weak in relation to the maintenance of a proper balance of executive and non-executive directors on the board.

Foreign Ownership and Compliance to BSI practices:

The level of compliance of SFO companies is higher than that of LFO companies. Compliance requires boards having at least 50% of NEDs; boards having independent directors; the selection of NEDs by the board or nomination committees; and, the ability of NEDs to meet without the presence of executive directors in order to discuss company affairs (refer items 1, 2, 6 and 7 of Table 5.29). Both categories have adequate numbers of independent directors represented, but are weaker in maintaining a balance between executive and NEDs. It is evident that the presence of foreign owners has significantly improved the NEDs and independent directors' representations as well as their participation in board activities. The independence of NEDs is also secured by implementing proper appointment procedures and by facilitating separate meetings for NEDs. This evidence indicates that the presence of foreign owners has a positive influence on best governance practices of Sri Lankan companies.

Table 5.29 Board Structure and Independence

Observed Variables	Overall	Family Ownership		Foreign Ownership		Controlling Owners	
		FB	NFB	LFO	SFO	Yes	No
BSI Sub-index	**64%**	**61%**	**66%**	**63%**	**69%**	**62%**	**69%**
1. Board has at least 50% non-executive directors (NEDs)	78%	70%	84%	74%	92%	77%	82%
2. Board has independent directors	97%	91%	100%	96%	100%	95%	100%
3. CEO is not chairman of the board	77%	78%	76%	79%	69%	77%	76%
4. Majority of NEDs are independent	53%	57%	51%	53%	54%	49%	65%
5. Maintain balance of executive and NEDs	28%	43%	19%	30%	23%	26%	35%
6. Selection of NEDs is done by the board or nomination committee	72%	65%	76%	68%	85%	65%	88%
7. Non-executive directors meet without executive directors to discuss firm affairs	43%	26%	54%	38%	62%	47%	35%

Note: FB – Family Based Companies; NFB – Non Family Based Companies;
LFO – Less Foreign owned companies; SFO – Substantially Foreign Owned companies

Controlling Ownership and Compliance to BSI Practices:

The presence of controlling shareholders, who consist of both family owners and foreign owners if they are functioning as controlling shareholders, has a negative impact on compliance with best governance practices. This is observed in relation to: having at least 50% NED's on the board; the appointment of independent directors to the board; having a majority of independent directors within the NEDs; and, selection of NEDs by the board or nomination committee (refer items 1, 2, 4 and 6; Table 5.29). Directors' independence is protected if they are not employed in the company, and if they do not have a close relationship with any of the company's affairs. The low level of compliance with these practices suggests that the presence of controlling shareholders negatively impacts on the board independence of those companies.

b) Board Procedure and Effectiveness (BPE)

Family Ownership and Compliance to BPE Practices

The levels of compliance of both sub samples of family ownership based sub-samples are high in respect of: directors attending at least 75% of meetings on average; firms holding four or more regular board meetings per year; directors demonstrating financial acumen; recording of dissents in board minutes; and, NEDs' not receiving

retirement pay. However, the survey results provide strong evidence that the compliance level of FB companies is lower, compared to NFB companies for all the boards' procedures and practices surveyed. Of these, significantly lower compliance is found in some practices. Namely they are: the existence of nomination committees; nomination committees consisting exclusively of NEDs; board appointments made only through nomination committees; firms having systems to evaluate their CEOs and directors; firms having board meetings for extended time periods; and, NEDs' obtaining professional advice at their companies' expense (refer items 8, 9, 11, 15, 18, 19, 20 and 31; Table 5.30).

Furthermore, the following practices have a low level of compliance by FB companies. These are namely: the chairing of the nomination committee by an independent director; transparent procedures for the election of directors; holding four or more board meetings annually; having board members with financial acumen; having succession plans for the CEO; and, having bylaws governing board meetings (refer items 10, 12, 14, 16, 21 and 32; Table 5.30).

The survey results indicate that the functioning of boards and board committees in the FB companies under review are particularly weak, even though corporate directors generally agree that their boards are a forum for discussion of significant corporate matters. In FB companies, boards seem to be inactive in: establishing nomination committees; evaluating the performance of CEOs; providing regular training for directors; and, having an ethical code for directors. They are particularly poor in evaluating and supporting NEDs so that they can contribute effectively as board members. Independent and NEDs are inadequately supported with necessary information by way of holding separate meetings with their chairman, and having access to outside professional services and education and training.

Foreign Ownership and Compliance to BPE Practices

The SFO companies have performed better in all board procedure practices surveyed except two, as shown in Table 5.30. This is particularly evident in relation to: the existence of nomination committees; making appointments to the board only through nomination committees; having one or more outside foreign directors; obtaining professional advice for NEDs at their company's expense; and, having bylaws to govern

board meetings (refer items 8, 11, 28, 31 and 32). Both sub samples show high levels of compliance in some practices such as: holding four or more board meetings annually; the board consisting of members with financial acumen; directors attending at least 75 per cent of meetings; recording dissents in the minutes; and, NEDs not receiving retirement pay. The only practices that are better adhered to by LFO companies are: that the nomination committee consists exclusively of NEDs; and, there are separate persons for the roles of CEO and chairperson.

The survey results show the presence of foreign ownership substantially improves the governance practices relating to board procedures, resulting in an efficient functioning of boards' activities. In the majority of SFO companies, the boards have: established nomination committees; secured formal and transparent procedures for appointing directors; conducted board meetings regularly; evaluated the performance of CEOs; provided regular training for directors; and, provided an ethical code for directors. These companies have also taken several measures to safeguard the independence of NEDs, securing their active involvement in board functions. In general, the presence of foreign owners has made a positive impact on every aspect of board functions.

Controlling Ownership and Compliance to BPE Practices

A negative impact resulting from a presence of controlling shareholders is seen in most board procedure practices surveyed. The negative impact is particularly high in respect of: establishing nomination committees; appointing directors; evaluating performances of the CEO and other directors; having a succession plan for the CEO; providing regular training; having a code of conduct for directors; ensuring accessibility of professional advice to NEDs; and, establishing bylaws to govern the procedures of board meetings. The inactive functioning of nomination committees suggests that appointments of directors are dominated by controlling shareholders. The true independence of NEDs is doubtful, judging from their role in the setting of a performance evaluation system for the CEO and executive directors, and the pattern of behaviour in conducting separate meetings with the chairperson.

Table 5.30 Board Procedure and Effectiveness

Observed Variables	Overall	Family Ownership		Foreign Ownership		Controlling Owners	
		FB	NFB	LFO	SFO	Yes	No
BPE Sub-index	**58%**	**49%**	**64%**	**54%**	**71%**	**56%**	**63%**
8. Nomination committee (NC) exits	45%	26%	57%	38%	69%	42%	53%
9. NC consists exclusively of NEDs	41%	17%	48%	50%	22%	44%	33%
10. NC is chaired by an independent director	70%	67%	71%	72%	67%	72%	67%
11. Appointments to the board are made only through the NC	37%	13%	51%	30%	62%	35%	41%
12. The firm has formal and transparent procedures for the election of directors	77%	70%	81%	74%	85%	67%	100%
13. Directors are subject to a limit on the number of directorships in other firms	23%	13%	30%	19%	38%	19%	35%
14. Firm holds four (4) or more regular board meetings per year.	93%	83%	100%	91%	100%	93%	94%
15. Board meetings run for an extended time period (over 2 hours)	68%	43%	84%	64%	85%	74%	53%
16. Board consists of members with sufficient financial acumen	93%	87%	97%	91%	100%	91%	100%
17. Directors attend at least 75% of meetings, on average	97%	96%	97%	96%	100%	98%	94%
18. The firm has a system to evaluate the CEO	58%	48%	65%	57%	62%	51%	76%
19. The firm has a system to evaluate other executive directors	50%	39%	57%	47%	62%	42%	71%
20. The firm has a system to evaluate NEDs	23%	9%	32%	21%	31%	21%	29%
21. The firm has a succession plan for the CEO	68%	61%	73%	68%	69%	65%	76%
22. The firm has a retirement age for NEDs	47%	48%	46%	43%	62%	49%	41%
23. Directors receive regular training	38%	30%	43%	30%	69%	37%	41%
24. The firm has a code of ethics for directors	43%	30%	51%	36%	69%	42%	47%
25. The board receives materials at least 7 days in advance of meetings	87%	91%	84%	85%	92%	88%	82%
26. The CEO and chairman are different people	77%	78%	76%	79%	69%	77%	76%
27. Dissents are recorded in the board minutes	92%	91%	92%	91%	92%	91%	94%
28. The firm has one or more foreign directors	38%	35%	41%	26%	85%	40%	35%
29. NED(s) do not receive retirement pay	100%	100%	100%	100%	100%	100%	100%
30. Chairman holds separate meetings for NEDs	27%	13%	35%	19%	54%	23%	35%
31. NEDs can obtain professional advice at the company's expense	60%	43%	70%	51%	92%	58%	65%
32. Bylaws to govern board meetings exist	62%	52%	68%	57%	77%	53%	82%

Note: FB – Family Based Companies; NFB – Non Family Based Companies;
LFO – Less Foreign owned companies; SFO – Substantially Foreign Owned companies

c) Audit Committee Procedure (ACP)

Family Ownership and Compliance to ACP

It is interesting to note that 100 per cent of firms have an audit committee, irrespective of the category into which they fall. However, FB companies perform relatively lower than NFB companies in relation to all aspects of audit committee

procedure, as shown in Table 5.31. This is particularly evident in relation to items 34, 35, 37, 41 and 42, as the majority of NFB companies appoint audit committees with clearly defined authorities and responsibilities covering a wide range of issues, compared to FB companies. Out of these variables, the independence of the directors is obvious in NFB businesses by the high percentages indicated in items 34, 37 and 41. Further, firms satisfying the recommended frequency of audit committee meetings is remarkably low (43%) in FB companies, when compared to NFB companies, indicating relatively low activities carried out by the audit committees of family owned companies. The lack of independence and the relatively low level of activities carried out by audit committees of FB companies clearly suggest that the family owners even have control over the functions of audit committees, although they are meant to be independent from the executives and owners.

Table 5.31 Audit Committee Procedure

Observed Variables	Overall	Family Ownership		Foreign Ownership		Controlling Owners	
		FB	NFB	LFO	SFO	Yes	No
ACP Sub-index	**85%**	**78%**	**90%**	**83%**	**94%**	**86%**	**90%**
33. Audit committee (AC) exists	100%	100%	100%	100%	100%	100%	100%
34. AC has a majority of independent directors	88%	74%	97%	87%	92%	88%	88%
35. The firm has terms of reference to govern AC	92%	78%	100%	89%	100%	88%	100%
36. AC recommends the external auditor to the board	86%	83%	89%	83%	100%	86%	88%
37. AC comprises of exclusively NEDs	80%	70%	86%	78%	85%	77%	88%
38. AC includes someone with accounting expertise	97%	96%	97%	96%	100%	98%	94%
39. AC prepares and distributes minutes for each AC meeting	76%	70%	81%	72%	92%	74%	81%
40. AC meets four or more times per year	67%	43%	81%	64%	77%	63%	76%
41. AC is chaired by an independent director	92%	87%	94%	91%	92%	93%	88%
42. AC meets with the auditor to review financial statements.	88%	83%	92%	85%	100%	88%	88%

Note: FB – Family Based Companies; NFB – Non Family Based Companies;
LFO – Less Foreign owned companies; SFO – Substantially Foreign Owned companies

Foreign Ownership and Compliance to ACP

The SFO companies have better compliance with recommended audit committee practices. Practices to ensure full compliance are: setting terms of reference to govern

the audit committee; recommending the external auditor to the full board, meeting external auditors to review financial statements; and, having someone with accounting expertise on the committee. This indicates SFO companies have active functioning committees. Furthermore, they demonstrate greater concern for the committee relationship with the external auditors and the independence of the committees, as revealed by higher percentages of compliance in items 34, 36, 37, 41 and 42 of Table 5.31. The frequency of committee meetings of SFO companies also indicates the active functioning of these committees, indicating foreign ownership has a positive influence on securing the independence and efficiency of audit committees.

Controlling Ownership and Compliance to ACP

The analysis shows diverse behaviour in relation to audit committee practices. However, the majority of practices surveyed show relatively low compliance by the companies with controlling shareholders, for example, having written terms of reference for the audit committee, and a committee comprising exclusively of NEDs. The frequency of committee meetings is also relatively low in companies with controlling shareholders. However, there is not much variation concerning other practices between the sub samples. This indicates that the controlling shareholders have less influence over their audit committees.

d) Directors' Remuneration Procedures (DRP)

Family Ownership and Compliance to DRP

The survey results show that the level of compliance of FB companies to recommended directors' remuneration practices is lower in most cases compared to those of NFB companies. The existence of: a remuneration committee; setting a remuneration policy; formulating performance-based remuneration schemes; and reviewing compensation packages, are essential for securing objective remuneration policies. However, FB companies show low compliance levels with these practices. Only 68per cent of FB companies surveyed have a remuneration committee comprising a majority of NEDs, questioning their independence. The independent directors' participation in remuneration committees, the written policies on directors' remuneration and the formulation of performance based remuneration schemes seem to be less essential for FB companies, indicating the power of family ownership in deciding remuneration policies.

Table 5.32 Directors' Remuneration Procedures

Observed Variables	Overall	Family Ownership		Foreign Ownership		Controlling Owners	
		FB	NFB	LFO	SFO	Yes	No
DR Sub-index	**68%**	**61%**	**72%**	**66%**	**74%**	**67%**	**69%**
43. RC exists	97%	96%	97%	96%	100%	98%	94%
44. RC comprises majority of independent directors	78%	68%	83%	78%	77%	79%	75%
45. RC chaired by an independent director	81%	91%	75%	82%	77%	83%	75%
46. Company has a written policies on directors' remuneration	67%	50%	78%	62%	85%	69%	63%
47. Executive directors' remuneration is (at least part) performance based	63%	39%	78%	62%	69%	58%	76%
48. The board review CEO compensation annually	75%	61%	84%	74%	77%	70%	88%
49. Executive Directors' Incentive Schemes are approved by the Shareholders	12%	13%	11%	11%	15%	12%	12%
50. Dissents are recorded in the RC minutes	81%	86%	78%	78%	92%	79%	88%

Note: FB – Family Based Companies; NFB – Non Family Based Companies;
LFO – Less Foreign owned companies; SFO – Substantially Foreign Owned companies

Foreign Ownership and Compliance to DRP

The SFO companies show better commitment to governance practices relating to directors' remuneration than that of LFO companies. This is evident from higher compliance to most of the remuneration practices surveyed in the study. In particular, the existence of remuneration committees in all SFO companies and a written remuneration policy for the majority of companies, suggests that foreign ownership applies pressure to boards to establish proper procedures and policies concerning directors' remuneration.

Controlling Ownership and Compliance to DRP

The existence of controlling owners impacts on directors' remuneration procedures and policies. The survey indicates relatively low compliance with recommended practices by the companies with controlling shareholders. For example, practice regarding performance-based remuneration is less compliant by the companies with controlling owners than recommended practices. This is further evident from the practices listed in items 48 and 50 of Table 5.32, which substantiate the controlling shareholders' negative influence on directors' remuneration and committee procedures.

e) Disclosure Substance (DS) and Disclosure Reliability (DR)

Family Ownership and Compliance to DS and DR Practices

Both sub samples have fully complied with disclosing Statements of Corporate Governance, RPTs, and resumes of directors (refer items 56 and 57 and 63; Table 5.33) which are mandatory requirements under the *Colombo Stock Exchange Listing Rules* of 2009. Furthermore, both sub samples show relatively low compliance with regard to the disclosure of information on the web compared to disclosures in the Annual Reports. It seems that Sri Lankan companies greatly rely on Annual Report disclosures instead of disclosing relevant information through their web sites. Apart from these distinguishing features, the level of compliance of FB companies is relatively low for all the disclosure practices surveyed.

In FB companies, the levels of web disclosures are exceedingly low, indicating voluntary disclosers are not encouraged by these companies. For example, while FB companies fully comply with publishing Corporate Governance Statements in their Annual Reports, a very low percentage (4%) publishes their Corporate Governance Reports on the web.

The family owners' negative influence on voluntary disclosures is further evident by the very low percentage (22%) of companies disclosing their directors' share dealings on their company's web site. Annual Report disclosures also show that FB companies have a relatively low level of disclosure for all the practices surveyed. Concerning disclosures of committee reports, it is clear that FB companies have lower disclosure (items 58, 59 and 60; Table 5.33) than that of their counterparts. Though the disclosure of directors' remuneration has been unsatisfactory in both sub samples, it is remarkably low for FB companies. The separate disclosure of audit and non-audit fees also shows poor compliance by FB companies. This evidence suggests that while voluntary disclosures remain at low levels for all the companies under review, the issue of low voluntary disclosure is further aggravated by the existence of controlling family ownership in Sri Lankan companies.

Disclosure reliability always goes hand in hand with the external auditor since it is an auditor's responsibility to give an opinion on the financial information. In this respect, securing external auditors' independence is important in enhancing the

reliability of financial information. The level of compliance regarding the audit committee review, and the rotation of audit partners securing auditors' independence is higher in NFB companies compared to those of FB companies (refer items 68, 69 and 70; Table 5.34). This provides further evidence that FB companies show a lack of interest not only in providing voluntary information, but also in protecting the reliability of financial information.

Table 5.33 Disclosure Substance

Observed Variables	Overall	Family Ownership		Foreign Ownership		Controlling Owners	
		FB	NFB	LFO	SFO	Yes	No
DS Sub-index	**66%**	**58%**	**72%**	**64%**	**74%**	**64%**	**71%**
Web disclosures							
51. Firm put directors' shares dealings on the web	23%	22%	24%	19%	38%	23%	24%
52. Discloses quarterly financial statements on the web	55%	43%	62%	51%	69%	49%	71%
53. Firms put their Annual Report on the web	62%	43%	73%	60%	69%	60%	65%
54. Firms put the Directors' Report on the web	57%	43%	65%	53%	69%	58%	53%
55. Discloses Corporate Governance Report on the web	12%	4%	16%	11%	15%	9%	18%
Annual Report (AR) Disclosures							
56. Disclose a Statement of Corporate Governance in the AR	100%	100%	100%	100%	100%	100%	100%
57. Disclose RPTs in the AR	100%	100%	100%	100%	100%	100%	100%
58. Disclose AC Report in the AR	90%	78%	97%	87%	100%	88%	94%
59. Disclose RC Report in the AR	73%	61%	81%	66%	100%	72%	76%
60. Disclose NC Report in the AR	67%	50%	71%	61%	78%	61%	78%
61. Disclose Risk Management Policies in the AR	82%	74%	86%	83%	77%	81%	82%
62. Disclose membership of AC, RC and NC	97%	91%	100%	96%	100%	95%	100%
63. Disclose Resume of directors in the AR	100%	100%	100%	100%	100%	100%	100%
64. Disclosure of Directors' Remuneration	28%	22%	32%	28%	31%	26%	35%
65. Disclosure of Audit and Non-audit fees separately in the AR	85%	70%	95%	85%	85%	79%	100%

Note: FB – Family Based Companies; NFB – Non Family Based Companies;
LFO – Less Foreign owned companies; SFO – Substantially Foreign Owned companies

Foreign Ownership and Compliance to DS and DR Practices

The level of disclosure of SFO companies is higher than that of LFO companies across all disclosure practices surveyed, showing a positive impact of foreign share ownership on disclosures. With regard to web disclosures, SFO companies have done better, particularly in disclosing financial statements and directors' reports, compared to

LFO companies (refer items 52, 53 and 54; Table 5.33). Similarly, the disclosure of committee reports has been well adhered to by SFO companies, indicating these companies not only ensure the proper functioning of board sub committees, but are also interested in communicating those procedures to shareholders to enhance confidence among non-controlling shareholders. However, it seems that foreign ownership achieves limited success in disclosing directors' share dealings and remuneration.

The measures taken by SFO companies to protect the reliability of information are higher than that of LFO companies. Practices such as rotating audit partners and reviews conducted by the audit committees, which are essential in protecting an external auditor's independence, are compliant more often in the case of SFO companies, compared to LFO companies. However, SFO companies obtain more non-audit services from their external auditors, which is detrimental to the independence of external auditors. Apart from this, SFO companies better protect all other practices, safeguarding the auditor's independence and suggesting foreign ownership has a positive influence on protecting disclosure reliability in Sri Lanka.

Table 5.34 Disclosure Reliability - Auditor Independence

Observed Variables	Overall	Family Ownership		Foreign Ownership		Controlling Owners	
		FB	NFB	LFO	SFO	Yes	No
DR Sub-index	**81%**	**81%**	**82%**	**80%**	**86%**	**81%**	**81%**
66. Auditor does not provide non-audit services or non-audit fees are <20% of total auditor fees	70%	74%	68%	74%	54%	72%	65%
67. Full board reviews auditor's recommendations	95%	100 %	92%	94%	100%	95%	94%
68. Audit partner is rotated every 5 years	68%	65%	70%	66%	77%	67%	71%
69. AC recommends the external auditor to full board	86%	83%	89%	83%	100%	86%	88%
70. AC conduct a formal review of the auditor's work	88%	83%	92%	85%	100%	86%	94%

Note: FB – Family Based Companies; NFB – Non Family Based Companies;
LFO – Less Foreign owned companies; SFO – Substantially Foreign Owned companies

Controlling Ownership and Compliance to DS and DR Practices

The level of disclosures both on the web and in annual reports is lower for the companies with controlling shareholders. It is clearly visible in respect of the disclosure of both quarterly and annual financial statements on the web. A similar behaviour is observed in the annual reports in respect of disclosure of board sub committees' reports

and non-audit fees (refer items 58, 59, 60 and 65). However, the practices required to protect disclosure reliability shows diverse behaviour between both sub samples.

f) Related Party Transactions (RPTs)

Family Ownership and Compliance to RPTs Practices

Table 5.35 shows the impact of family ownership on the nature, volume and the required approval level for RPTs. The results confirm that FB companies compared to NFB companies carry out a relatively higher number of RPTs in the form of trade transactions, loans and property leases or rented properties. The volume of RPTs is also larger in FB companies. The approvals of shareholders, the audit committee, or non-conflicted directors are not required to generate RPTs with executives and controlling shareholders for the majority of companies in both sub samples (refer items 77 and 78, Table 5.35). However, the exceedingly low required approval level in FB companies indicates that the family owners have full control over RPTs.

Table 5.35 Related Party Transactions

Observed Variables	Overall	Family Ownership		Foreign Ownership		Controlling Owners	
		FB	NFB	LFO	SFO	Yes	No
RPT Sub-index	**58%**	**55%**	**60%**	**58%**	**59%**	**56%**	**64%**
71. Firm does not have loans with insiders	83%	83%	84%	81%	92%	84%	82%
72. Firm does not have significant sales to or purchases from insiders	78%	74%	81%	79%	77%	84%	65%
73. Firm does not rent real property from or to an insider	78%	83%	76%	79%	77%	70%	100%
74. Firm had negligible revenue from RPTs (0-1% of sales)	42%	35%	46%	47%	23%	33%	65%
75. RPTs are reviewed by the board in the last year	82%	74%	86%	79%	92%	74%	100%
76. RPTs are on arms-length terms	88%	83%	92%	87%	92%	86%	94%
77. RPTs with executives approved by non-conflicted directors or AC or shareholders	7%	4%	8%	4%	15%	9%	0%
78. RPTs with controlling shareholders approved by non-conflicted directors or AC or shareholders	5%	4%	5%	6%	0%	5%	6%

Note: FB – Family Based Companies; NFB – Non Family Based Companies;
LFO – Less Foreign owned companies; SFO – Substantially Foreign Owned companies

Foreign Ownership and Compliance to RPTs Practices

Foreign ownership does not materially change the nature, volume or required approval level of RPTs. Both sub samples in the foreign ownership group show comparable results for most of the aspects surveyed in relation to RPTs. A relatively high volume of RPTs are carried out by companies in both sub samples, and the majority of companies (over 95%) do not require shareholders' or non-conflicting directors' approval to initiate RPTs. This raises doubts as to how the boards deliver accountability towards their stakeholders, including non-controlling shareholders, with respect to RPTs.

Controlling Ownership and Compliance to RPTs Practices

As discussed in Section 5.4.8, one persistent problem of RPTs in Sri Lankan companies is the presence of dominant shareholders, who are instrumental in initiating RPTs. As revealed in the results, companies with controlling shareholders are involved with a large number of RPTSs in terms of property leases or rent transactions (refer items 73; Table 5.35). It is observed that there is a lack of a full board review, and the low levels of approvals required for companies with controlling owners (refer items 75, 77 and 78). The required level of approval is low for both sub samples. However, a lack of board review and low approval levels, in combination with the presence of controlling owners, could be detrimental to the objective and impartial functioning of RPTs, indicating possible misappropriation of resources causing value deterioration of such firms.

g) Shareholders' Rights (SR)

Family Ownership and Compliance to SR

In the family ownership based sub sample, both categories have adequately complied with practices relating to shareholders' rights. Almost all companies in both sub samples have complied with shareholders' voting rights (refer items 79 and 82 in Table 5.36) which is a mandatory requirement of the *Sri Lankan Companies Act* 2007. The companies in both sub samples have adequately complied with proxy rights providing an opportunity to shareholders to appoint a representative to be present and vote at the AGM on their behalf. On the other hand, there is no practice in Sri Lankan quoted public companies to include a separate item on the AGM's agenda to provide shareholders with an opportunity to raise questions. However, companies of both

categories give an opportunity to their shareholders to express their views. (refer to item 86). Similarly high compliance is noted in both sub samples regarding the board sub committees' chairmen participating in the AGM to answer shareholders' questions (refer to item 87). However, as for: transparency issues of RPTs; guidelines in respect of directors' share dealings; and, having board representation from minority shareholders, it is obvious that NFB companies have better compliance than the FB companies (refer items 84, 89 & 90 of Table 5.36). Apart from these aspects, family ownership does not have any material impact, either positive or negative, on shareholders' rights.

Foreign Ownership and Compliance to SR

In many aspects of shareholders' rights, the SFO companies show higher compliance than do LFO companies. The SFO companies compared to LFO companies (refer items 81 and 82 of Table 5.36) exercise a higher percentage of voting by mail and proxy rights. While both groups allow time for shareholders to raise questions at the AGM (refer item 86, Table 5.36), a higher percentage of compliance is noted in the SFO category regarding revealing director candidates prior to the AGM, and the presence of committee chairmen at board meetings to answer questions (refer items 85 and 87). Regarding transparency issues of RPTs, and guidelines in respect of directors' share dealings, it is obvious that SFO companies have better compliance than LFO companies (refer items 89 and 90 of Table 5.36). Such evidence supports the argument that the presence of foreign owners enhances the protection of shareholders' rights in Sri Lanka.

Controlling Ownership and Compliance to Shareholder Rights

The results show that the existence of controlling shareholders impacts on the protection of shareholders' rights. A higher percentage of proxy rights and a weaker percentage of voting by mail are common features in both sub samples (refer items 81 and 82 of Table 5.36). Furthermore, adequate time is allowed to shareholders to raise questions at the AGM by both sub groups (refer item 86 of Table 5.36). However, the companies with controlling owners have lower compliance regarding the following practices: revealing directorship candidates prior to the AGM; the presence of committee chairmen at board meetings to answer questions; disclosure of RPTs at shareholders' meetings, and the availability of guidelines for directors' share dealings (refer items 85, 87, 89 and 90 of Table 5.36). The existence of controlling shareholders results in the erosion of some rights of non-controlling shareholders.

Table 5.36 Shareholder Rights

Observed Variables	Overall	Family Ownership		Foreign Ownership		Controlling Owners	
		FB	NFB	LFO	SFO	Yes	No
SR Sub-index	**80%**	**78%**	**81%**	**79%**	**83%**	**79%**	**81%**
79. There is no deviation from the one share-one vote rule	90%	91%	89%	91%	85%	93%	82%
80. Directors serve three-year terms	93%	91%	95%	94%	92%	91%	100%
81. Firm allows voting by mail	28%	30%	27%	23%	46%	28%	29%
82. Anybody can serve as a proxy	97%	96%	97%	96%	100%	98%	94%
83. There is no extraordinary meeting on the shareholders' request in the last 3 years	90%	96%	86%	89%	92%	88%	94%
84. Board has one or more minority shareholder representatives	40%	35%	43%	43%	31%	42%	35%
85. Firm discloses directorship candidates to shareholders prior to the AGM	72%	61%	78%	70%	77%	67%	82%
86. Adequate time is given to shareholders to ask questions at the AGM.	100%	100%	100%	100%	100%	100%	100%
87. Chairpersons of Board Committees are available at the AGM	95%	96%	95%	94%	100%	93%	100%
88. Shareholders' priority subscription right in the issuance of shares or convertible bonds is adequately protected	97%	96%	97%	96%	100%	98%	94%
89. RPTs are fully discussed with adequate information at the shareholders' meeting	97%	96%	97%	96%	100%	95%	100%
90. There are written guidelines in respect of directors' share dealings with the firm	57%	48%	62%	53%	69%	56%	59%

Note: FB – Family Based Companies; NFB – Non Family Based Companies;
LFO – Less Foreign owned companies; SFO – Substantially Foreign Owned companies

5.5.3 Impact of Ownership on Level of Corporate Governance Compliance

The comparative analysis of sub indices scores (refer Section 5.5.2.1), and the analyses of ownership impacts on individual practices (refer Section 5.5.2.2), suggest that corporate ownership influences the level of compliance to regulations of corporate governance practices in Sri Lankan companies. The impact of ownership on the level of compliance is verified statistically in this section in order to provide evidence on the findings of the preceding sections.

5.5.3.1 Impact of Family Ownership

The results of the comparative analysis of the corporate governance sub indices (refer Table 5.28) and individual practices (refer Section 5.5.2.2) indicate that family ownership negatively influences corporate governance practices in Sri Lankan companies. In order to provide robust evidence on these issues, a t-test for independent samples using family based sub samples is performed. The purpose of this test is to discover whether there is a statistically significant difference between the sub samples. Furthermore, it identifies the most affected dimensions of corporate governance.

Table 5.37 Results of t-test on Index Scores - Family based Sub-samples

This table shows the statistical significance of the corporate governance index score and sub-indices scores of two sub samples identified based on family ownership. The statistical significance is examined based on the independent sample t-test.

CG Index	Mean		Std. Deviation		Mean Difference	T	df	Sig. p-value
	FB	NFB	FB	NFB				
BSI	4.30	4.59	1.46	1.040	-.290	-.899	58	.372
BPE	12.22	15.97	4.61	4.573	-3.756***	-3.083	58	.003
ACP	7.83	8.97	1.67	1.607	-1.147**	-2.648	58	.010
DRP	4.91	5.76	1.70	1.188	-.844**	-2.260	58	.028
DS	8.65	10.73	2.93	1.851	-2.078***	-3.371	58	.001
DR	4.04	4.08	0.77	.862	-.038	-.171	58	.865
RPT	4.39	4.78	0.99	1.031	-.392	-1.456	58	.151
SR	9.35	9.68	1.47	1.180	-.328	-.953	58	.344
Overall Index	**55.70**	**64.57**	**9.46**	**8.444**	**-8.872*** **	**-3.777**	**58**	**.000**

*Level of significance: ***1% level and **5%level (based on the 'p-value' of t-statistics)*

As shown in Table 5.37, there are negative mean differences across all sub indices and the overall index. This suggests that the level of corporate governance compliance of FB companies is lower than that of NFB companies. The negative mean difference for the overall governance index is statistically significant at the 1% level. Furthermore, the negative mean differences of four sub indices are statistically significant. The mean differences of the board procedure and effectiveness sub index and the disclosure substance sub index are significant at the 1% level, whereas the mean difference of the audit committee procedure index and the directors' remuneration index are significant at the 5% level. These results therefore statistically confirm that family ownership has a negative impact on the compliance of corporate governance best practices in Sri Lankan companies.

The results indicate that the most negatively affected governance dimensions are: board procedure; audit committee procedure; directors' remuneration procedure; and, disclosure substance. The results confirm the findings of previous research studies carried out on the relationship between family ownership and corporate governance. Nam and Nam (2004) claim that most large corporations owned and controlled by families have their members holding key managerial positions. They further state that corporate management tends to consist of controlling owners, and therefore boards of directors in family-based enterprises serve primarily the interests of controlling families rather than those of all shareholders. This behaviour appears to be true in Sri Lanka, as board procedures and directors' remuneration procedures have least priority by family controlled companies.

Cheung and Chan (2004) state that the most significant corporate governance issue caused by family ownership is the alignment of interests between the controlling shareholders and the non-controlling shareholders. The proper functioning of both the board and the audit committee and adequate disclosures are important dimensions of corporate governance in safeguarding minority shareholders' rights. However, a lack of emphasis placed on these aspects indicates that minority shareholders' rights are not adequately protected in Sri Lankan family owned companies. The lack of applicability of the Sri Lankan *Corporate Governance Code*, which has been developed on the fundamentals of the Anglo-Saxon model, could contribute to the low level of governance compliance experienced by family owned companies. Iu and Batten (2001) observe that Asian cultures significantly impede the implementation of the Anglo-Saxon model of corporate governance. The relationship-based business, especially within the family owned group affiliation, is a common cultural tendency in Sri Lanka. Thus, the results suggest that the Anglo-Saxon model is more alien within the family-based companies where both ownership and management tend to be concentrated with family members.

5.5.3.2 Impact of Foreign Ownership

The impact of foreign ownership on firm compliance with corporate governance practices is also tested using a t-test for independent samples, to discover whether there is a statistically significant difference between sub-samples recognized based on foreign ownership of the sample companies. Findings indicate (refer Section 5.5.2) that the presence of foreign ownership enhances the level of compliance with corporate

governance best practices of Sri Lankan companies. The results of the t-test, given in Table 5.38 provide further evidence to support this claim.

Table 5.38 Results of t-test on Index Scores - Foreign based Sub-samples

This table shows the statistical significance of the corporate governance index score and sub-indices scores of two sub samples identified based on foreign ownership. The statistical significance is examined based on the independent sample t-test.

CG Index	Mean		Std. Deviation		Mean Difference	T	df	Sig. p-value
	SFO	LFO	SFO	LFO				
BSI	4.85	4.38	1.144	1.23	.463	1.222	58	.227
BPE	17.85	13.62	5.080	4.49	4.229***	2.920	58	.005
ACP	9.38	8.30	.870	1.82	1.087***	3.033	58	.004
DR	5.92	5.30	1.115	1.52	.625	1.383	58	.172
DS	11.08	9.62	2.100	2.55	1.460**	2.112	58	.046
DR	4.31	4.00	.630	0.86	.308	1.201	58	.235
RPT	4.69	4.62	1.032	1.03	.075	.233	58	.817
SR	9.92	9.45	1.038	1.35	.476	1.178	58	.244
Overall Index	**68.00**	**59.28**	**7.927**	**9.47**	**8.723*** **	**3.035**	**58**	**.004**

*Level of significance: ***1% level and **5%level (based on the 'p-value' of t-statistics)*

The results show that there are positive mean differences in scores of the overall index and the sub indices. This suggests that the level of corporate governance compliance of SFO companies is higher than that of LFO companies. The positive mean difference for the overall governance index is statistically significant at the 1% level. The result confirms that companies with foreign ownership have healthier governance structures, which encourages them to comply with most of the best corporate governance practices recommended by SLCGC (2008). Furthermore, the positive mean differences of the BPE sub index score and the ACP sub index score are statistically significant at the 1% level, while the mean difference of the DS sub index score is statistically significant at the 5% level. This provides further evidence that board procedures, audit committee procedures, and disclosure requirements are better complied with by foreign owned companies compared to their counterparts. These results statistically confirm that foreign ownership has a positive impact on compliance with corporate governance best practices by Sri Lankan companies.

The results are consistent with the findings of prior research studies on corporate ownership. Nam and Nam (2004) in their study on corporate governance in Asia, found that firms substantially owned by foreigners have much higher corporate governance

compliance in Asian countries, especially in Korea. They further observe that the substantially foreign-owned firms tend to have a more effective board of directors. The foreign owners generally demand higher quality corporate governance. A similar behaviour is observed in substantially foreign owned Sri Lankan companies. The high compliance with board procedures, audit committee procedures, and corporate disclosures, indicate foreign owners are particularly interested in establishing good internal governance structures. Furthermore, the results suggest that substantially foreign-owned companies are likely to be more comfortable with an Anglo-Saxon model of corporate governance, compared with family owned companies.

5.5.3.3 Impact of Controlling Ownership

Although high ownership concentration is common among Asian corporations (Claessens and Fan, 2002, Balasubramanian et al., 2010), its impact on corporate governance is less explored in the Asian context. A high ownership concentration is observed amongst surveyed companies (refer Table 5.5), with the presence of controlling shareholders in the majority of companies surveyed (refer Table 5.6). The comparative analysis (refer Section 5.5.2) found a negative impact of controlling ownership on corporate governance in Sri Lankan companies. However, the claim that a presence of controlling shareholders acts as an impediment to establishing efficient governance structures and causes low levels of compliance to corporate governance best practices, requires further evidence to prove the validity of this claim. With a view to providing further evidence to support this claim, a t-test for independent samples, using categories of the presence or the absence of controlling shareholders, is carried out, The results of this test is given in the Table 5.39.

The results show that there are negative mean differences across all sub indices scores and the score of the overall index. This suggests that the presence of controlling shareholders is detrimental to establishing effective governance structures in these companies. Furthermore, the negative mean differences of BSI sub index score and RPT sub index score are statistically significant at the 5% and 10% levels respectively. This indicates that the most negatively affected corporate governance dimensions are RPTs and the structure and independence of board. These findings are consistent with prior research findings and assertions. Claessens and Fan (2002) state that: weak enforcement of property rights; weak legal systems; poor law enforcement; and, corruption are the most probable causes of concentrated ownership of Asian companies, and that this

contributes to controlling shareholders expropriating minority shareholders' resources. Particularly, the low level of compliance relating to board structure and independence, and RPTs, raises similar concerns in Sri Lanka as controlling shareholders frequently use RPTs as a vehicle for expropriating resources from minority shareholders

Table 5.39 Results of t-test on Index Scores - Controlling Ownership

This table shows the statistical significance of the corporate governance index score and sub-indices scores of two sub samples identified based on ownership concentration. The statistical significance is examined based on the independent sample t-test.

CG Index	Mean		Std. Deviation		Mean Difference	t	df	Sig. p-value
	Con OS	Disp. OS	Con OS	Disp. OS				
BSI	4.35	4.82	1.33	0.81	-0.475*	-1.375	58	0.098
BPE	14.05	15.76	4.77	5.19	-1.718	-1.227	58	0.225
ACP	8.56	8.47	1.48	2.24	0.088	0.177	58	0.860
DR	5.40	5.53	1.24	1.94	-0.134	-0.319	58	0.751
DS	9.67	10.59	2.50	2.50	-0.914	-1.274	58	0.208
DR	4.07	4.06	0.80	0.90	0.011	0.046	58	0.963
RPT	4.44	5.12	1.03	0.86	-0.676**	-2.393	58	0.020
SR	9.49	9.71	1.33	1.21	-0.218	-0.583	58	0.562
Overall Index	60.02	64.06	9.22	10.87	-4.036	-1.452	58	0.152

*Level of significance: ***1% level and **5%level (based on the 'p-value' of t-statistics)*

Note: Con OS – Controlling Ownership; Disp. OS – Dispersed Ownership

5.6 Impact of Corporate Governance Compliance on Firm Performance

Better corporate governance is supposed to lead to better corporate performance, by preventing expropriation by controlling shareholders, and ensuring better decision making. Good governance restricts the expropriation of corporate resources by managers and controlling shareholders and contributes to a better financial performance (Irena, 2006). Investors are willing to invest more in better-governed companies because of the lower cost of capital, contributing to better share performance for those companies (Jianguo et al., 2006). However, there is a dearth of studies exploring the relationship between the quality of corporate governance and firm performance. Furthermore, observations show that the high ownership concentration in Sri Lankan companies is creating negative impacts on corporate governance (refer Section 5.5.3). This study assesses the extent of such a link based on a questionnaire survey, and in doing so realizes the fifth objective of the study; the impact of compliance with corporate governance best practices on the firm performance of Sri Lankan listed

companies. This is examined on the premise that better governance enhances firms' performance.

In order to examine the performance implications of corporate governance compliance, the sample divides into two sub samples, as high compliance and low compliance companies based on the overall index score. The maximum possible value of the overall index score is 90. Based on mean value of the index score, a company that has scored 61 or more for the overall index is defined as a high compliance company, whereas an overall index score less than 61 is considered as a low compliance company. Under this objective the sub samples of high and low compliance companies are analysed in relation to both financial performance and market performance, based on correlation analysis and t-tests for the independent sample as indicated in Section 4.5.3.4. The analysis addresses two issues: first whether high corporate governance compliance improves the financial performance of Sri Lankan companies; and, secondly whether high corporate governance compliance improves the market performance of Sri Lankan companies. The results of these analyses are presented and discussed in the subsequent sections.

5.6.1 Summary Statistics

The key descriptive statistics of the overall index score and the performance variables are reported in Table 5.40. As per this table, the mean overall index score is 61 (out of 90), with a standard deviation of 9.7, and high dispersion values, between a minimum of 39 and a maximum of 80. Similar behaviour is indicated in respect of high compliance as well as low compliance in the sub sample. This indicates that compliance to corporate governance best practice varies substantially across companies. As shown in the Table 5.40, the ROA of firms in the sample have a mean value of 5.3 per cent, and a high standard deviation, as well as high dispersion between the minimum and maximum values. However, the mean values of the ROA between high compliance and low compliance sub samples differ significantly, with a positive mean value for high compliance companies and a negative mean value for low compliance companies. This suggests that high compliance leads to companies' better financial performance. A similar behaviour emerges in respect of return on equity (ROE). Thus, financial performance measures appear to improve with an increase in compliance with corporate governance best practices. On the contrary, the mean values of both market performance

measures (Tobin Q and MBR) are high for the low compliance sub sample, compared with high compliance companies.

Table 5.40 Descriptive Statistics of Performance and Index Scores

This table shows the Descriptive Statistics of the firm performance and governance index score of the overall sample and two sub samples identified based on compliance to governance practices. A governance score value over 61 (out of maximum possible 90) is considered as high compliance whereas a value less than 61 is considered low compliance.

	Mean	Std. Devi.	Minimum	Maximum	N
Overall Sample					
Index Score	61.183	9.788	39	80	60
ROA	5.336	9.616	-8.290	46.754	
ROE	4.828	27.520	-156.676	103.156	
Tobin Q	1.088	0.443	0.468	3.535	
MBR	1.383	1.257	0.092	6.958	
Sub Sample of High Compliance Firms					
Index Score	67.639	5.861	61	80	36
ROA	9.031	10.519	-8.290	46.754	
ROE	14.193	17.799	-19.484	103.156	
Tobin Q	1.044	0.298	0.677	3.535	
MBR	1.055	0.689	0.092	6.958	
Sub Sample of Low Compliance Firms					
Index Score	51.458	5.445	39	58	24
ROA	-0.206	3.927	-6.305	24.582	
ROE	-9.220	33.428	-156.676	32.163	
Tobin Q	1.154	0.599	0.468	1.838	
MBR	1.875	1.706	0.449	4.753	

5.6.2 Correlations Analyses and t-test Results

Correlations:

The results presented in Table 5.41 indicate the extent of correlation between the overall index scores and performance variables used in this study. It shows that there is a positive relationship between the index score and financial performance measures. In the overall sample, there is a statistically positive relationship between the level of corporate governance and ROE at the 5% level. This indicates that financial performance tends to increase with an increase in the level of compliance to corporate governance. In the case of ROE, it is more likely that the level of compliance improves the ROE, as the correlation is statistically significant at the 5% level. In both sub samples, the financial performance measures and index score are positively correlated, indicating that governance compliance improves firms' performance.

However, both Tobin's Q and MBR negatively relate to the governance index score for the overall sample, as well as for the sub samples. The negative correlation suggests that high corporate governance compliance causes a negative impact on market prices. Thus, it is difficult to establish a clear relationship between compliance to corporate governance and performance of Sri Lankan firms. The relationship between governance compliance and financial performance is positive whereas it is negative for market performance measures. The negative relationship could derive from the market's anomalies and inefficiencies. Further analysis is required to recognize the causes of this behaviour.

Table 5.41 Correlation Matrix for Firm Performance and Index Scores

This table shows the correlation of firm performance and the governance index score of the overall sample and two sub samples identified based on compliance to governance practices. Governance score values over 61 (out of maximum possible 90) are considered as high compliance, whereas values less than 61 are considered low compliance.

Overall Sample	Index Score	ROA	ROE	Tobin Q	MBR
Index Score	1				
ROA	.198	1			
ROE	.333**	.610**	1		
Tobin Q	-.006	.139	.037	1	
MBR	-.200	.019	-.214	.826**	1
Sub Sample of High Compliance Firms					
Index Score	1				
ROA	.161	1			
ROE	.156	.866**	1		
Tobin Q	.007	.178	.070	1	
MBR	-.003	.188	.170	.963**	1
Sub Sample of Low Compliance Firms					
Index Score	1				
ROA	.222	1			
ROE	.248	.128	1		
Tobin Q	-.155	-.280	-.003	1	
MBR	-.224	-.167	-.436*	.672**	1

Note: ** and * indicate correlation significant at 1% and 5% respectively

The t-test for Independent Samples:

The summary statistics (Section 5.6.1) and the correlation analyses of the overall index scores and performance measures indicate that there is a positive relationship between corporate governance compliance and the financial performance of Sri Lankan companies. It further shows that the relationship is negative for market performance measures. In order to provide robust evidence on these issues, a t-test for independent

samples is undertaken based on high compliance and low compliance sub samples. The main purpose of the test is to discover whether there is a statistically significant difference in performance between these sub samples.

Table 5.42 Results of t-test on Performance and Index Scores

This table shows the statistical significance of both the firm performance and governance index scores of two sub samples identified based on compliance to governance practices. A governance score value over 61 (out of maximum possible score of 90) is considered as high compliance, whereas a value less than 61 is considered low compliance. The statistical significance is examined based on the independent sample t-test.

Performance and Index	Mean		Std. Deviation		Mean Difference	t	df	Sig. p-value
	High Comp. Firms	Low Comp. Firms	High Comp. Firms	Low Comp. Firms				
ROA	9.031	-0.206	10.519	3.927	9.237***	4.106	58	.000
ROE	14.193	-9.220	17.799	33.428	23.413***	3.528	58	.001
Tobin Q	1.044	1.154	0.298	0.599	-0.110	-0.945	58	.349
MBR	1.055	1.875	0.689	1.706	-0.819**	-2.591	58	.012
Index Score	67.639	51.458	5.861	5.445	16.181***	10.773	58	.000

*Level of significance: ***1% level and **5%level (based on the ‘p-value’ of t-statistics)*

The mean differences of ROA and ROE are positive and are statistically significant at the 1% level, as shown in Table 5.42. This provides robust evidence that compliance to corporate governance best practices has a significant positive relationship with the financial performance of Sri Lankan companies. On the contrary to the expected value implications of corporate governance, the mean differences for Tobin Q and MBR are negative, suggesting high corporate governance compliance causes negative price impacts in the market. This abnormal price behaviour could result from market anomalies and inefficiencies prevailing in the Sri Lankan stock market.

The results of financial performance are consistent with the findings of previous research carried out on the relationship between the quality of corporate governance and firm performance. The studies of Klapper and Love (2002), and Brown and Gorgens (2009) show that better corporate governance is highly correlated with better operating and financial performance of firms. Brown and Gorgens (2009) specifically found that companies with better corporate governance outperformed those companies that are less compliant in relation to ROA and earnings per share (EPS). Based on corporate governance rankings for 495 firms in 25 emerging markets, Klapper and Love (2002) found that better governance is highly correlated to operating performance. They also find that corporate governance provisions at the firm level matter more in countries with

weak legal environments. Consistent with these findings, the results of this study suggest that firm level corporate governance provisions play a critical role in improving financial performance of Sri Lankan companies. It also suggests that good governance possibly restricts the expropriation of corporate resources by managers and controlling shareholders, securing better financial performance of the companies, which operate in a weak legal enforcement environment.

Many empirical studies that investigate the relationship between corporate governance quality and firm value show positive results. For example, the studies of Black et al. (2003), Campos et al. (2002), Klapper and Love (2002) and Gompers et al. (2003) show a positive relationship between overall quality of corporate governance and the market value of firms. However, the results of this study show a negative relationship, possibly resulting from market anomalies prevailing in Sri Lanka. In most small markets, market prices are subject to manipulations, signalling, group behaviour, and mistakes (Kapopoulos and Lazaretou, 2007). In addition to market anomalies, variable measurement problems such as the use of the proxy Tobin's Q (refer Section 4.5.3.4) and the availability of a relatively small sample could have resulted in estimation errors. Due to these reasons, the validity of market performance measures is debatable, especially in an emerging market where market anomalies and inefficiencies play a dominant role in deciding the market price for securities. In order to address these problems, a further study with a larger sample incorporating both longitudinal and cross sectional data is carried out, the results of which are discussed in Chapter 6.

5.7 Summary

This chapter presents the findings of the empirical analysis relevant to objectives two to five of this study. The analysis of objective two reveals diverse compliance levels in relation to corporate governance practices recommended in the SLCGC. The functions of boards and board committees in the companies under review are generally weak. The boards seem to be inactive in: evaluating performance and replacing CEOs; evaluating performance and setting performance based remuneration packages for executives; and, establishing nomination committees. They are particularly poor in evaluating and supporting directors so that they may contribute effectively as board members. Non-executive and independent directors are inadequately supported, in being provided with: necessary information; access to outside professional services; and,

education and training. The minimum duration of AGMs, and a lack of participation in AGMs, suggests that shareholders do not utilize AGMs effectively, allowing controlling shareholders to have more freedom to make decisions for their own benefits. Irrespective of the high prevalence of RPTs, required levels of approvals to execute RPTs raises serious doubts about their independence. The inadequacy of voluntary disclosures is evident from the lack of information available on company web sites.

The analysis of objective three, based on the overall CGI, shows the level of compliance with corporate governance best practices varies considerably amongst companies under review, with a minimum index score of 39 being achieved, in contrast with a maximum score of 80. The level of compliance of each dimension of corporate governance as measured by the sub-indices, shows considerable variation indicating more emphasis is given to aspects that are protected by the *Sri Lankan Companies Act* (2007), or by the CSE bylaws. The surveyed companies are doing relatively well in applying audit committee procedures (85 per cent), and in recognizing the protection of shareholders' rights (80 per cent). Board procedures including the functioning of a nomination committee, and regulation of RPTs, are the least complied with corporate governance dimensions in Sri Lanka. Given high levels of ownership concentration in most Sri Lankan companies, addressing minority shareholders' concerns seems to be difficult.

Although ownership concentration is common for most companies, its impact on corporate governance depends on the nature of the concentration. Family ownership has a considerably negative impact, whereas foreign ownership has a significantly positive impact on corporate governance. The analysis of objective four revealed that family ownership has a statistically significant negative impact on: board procedures; firms' voluntary disclosures; audit committee procedures; and, directors' remuneration procedures. The foreign affiliations of sample companies have a significant positive impact on corporate governance generally, and a statistically significant impact on: board procedures; audit committee procedures; and, voluntary disclosures. The overall ownership concentration has a negative, but statistically insignificant impact as these positive and negative influences nullify the intensity of their ultimate effects. It suggests that policy makers need to give due consideration to the nature of ownership

concentration in formulating governance practices as the procedure of family owned companies is more reliant on relationship based activities.

The impact of corporate governance on firm performance shows mix results. The analysis of objective five revealed that the level of compliance with corporate governance regulations, measured based on the overall CGI scores, has a significantly positive impact on the financial performance of the sample companies. This indicates that better corporate governance leads to better operating and financial performance of Sri Lankan companies. The market performance measures show, however, a negative relationship with corporate governance compliance. This may result from market anomalies prevailing in Sri Lanka. It suggests that market regulations and monitoring mechanisms give adequate strength to restrain market irregularities such as insider trading and price manipulations.

Stakeholders' perceptions of internal and external corporate governance mechanisms and required governance strategies for Sri Lankan companies are analysed and presented in the next chapter.

Chapter 6 : Survey of Stakeholders' Perception of Corporate Governance: Analysis and Results

6.1 Introduction

The survey undertaken on corporate governance compliance (refer Sections 5.4 and 5.5) shows that internal corporate governance mechanisms, especially the functions of boards and board committees, are generally weak in Sri Lankan companies. Shareholders do not utilize AGMs effectively as suggested by the minimum duration of AGMs and a lack of participation in AGMs. Ownership is highly concentrated, allowing controlling shareholders them more freedom to make decisions for their own benefits. The high prevalence of RPTs with minimum approval requirements, suggests that the ability of controlling shareholders to use RPTs to their advantage. The inadequacy of voluntary disclosures is suggested by the lack of information available on company web sites. The boards seem to be inactive in evaluating performance, replacing CEOs, and setting performance based remuneration packages for executives. Non-executive and independent directors are inadequately supported with access to outside professional services and education and training. These identified weaknesses and limitations suggest that there might be a lack of confidence of stakeholders in the corporate governance of Sri Lankan companies. This chapter examines how these issues are *perceived* by various stakeholders of Sri Lankan companies, in order to identify the perceived effectiveness of corporate governance in Sri Lanka.

Having examined the condition of corporate governance in Sri Lankan companies through the survey conducted in January and February 2010, this chapter describes an empirical investigation on the perceptions of various stakeholders of Sri Lankan corporations in relation to: first their perceptions of these prevailing corporate governance issues; and secondly, how the stakeholders perceive these issues should be addressed in the Sri Lankan context. Prior studies on this aspect are confined to one or two stakeholder groups, or consider only internal stakeholders of the company. For example, Nam and Nam (2004) survey the opinions of executive and independent directors whereas Ho (2005) focuses on top executives of international companies. The opinion survey carried out by the KPMG Co in Sri Lanka (2007) focuses only on directors and executive officers, whereas the McKinsey Co's (2002) survey is based on the opinion of only institutional investors. As little is known about the views of various

stakeholders, this study examines the views of several internal and external stakeholder groups regarding best practices, strategies and key players who promote corporate governance in the context of the emerging market of Sri Lanka.

This chapter presents the empirical analysis and findings of objective six of the study by analysing data collected from the questionnaire. The analysis is presented in the following sequence. First, responses to the survey are analysed, and non-response bias is tested, to assess the validity of the findings. Secondly, characteristics such as educational and professional qualifications and work experience of respondents are examined. Thirdly, the stakeholders' opinions on current practices and major issues of corporate governance are analysed with respect to several topics: important components of the Sri Lankan corporate governance system; the implications of corporate governance on firm performance; the present state of corporate governance; contentious issues of corporate governance; corporate governance strategies; corporate governance practices needing improvement; key players and promoters of corporate governance; and, alternative approaches to promote corporate governance practices. In the next section, the recommendations made by stakeholders and further issues raised by them are analysed in order to identify their concerns about corporate governance. The summary is provided in the final section.

6.2 Survey Responses and Non-response Bias

The total number of usable responses to the questionnaire amounted to 277, giving a response rate of 42 per cent. The questionnaire distributed personally by the researcher achieved a higher response rate of 60 per cent, compared to mailed questionnaire which had a response rate of 29 per cent as only 109 of the 375 respondent returned their questionnaires. The breakdown of the responses of each stakeholder group is displayed in Table 6.1. The response rates within stakeholders' groups vary from 24 per cent to 73 per cent.

The overall response rate of 42 per cent compares favourably with those of previous studies, for example: Ho (2005) 10.4 per cent; and, Nam and Nam (2004) 29 per cent. The relatively high response rate could be due to the combination of methods used for distributing and collecting the questionnaires.

Table 6.1 Survey Responses by Category of Stakeholders

Category	Sample	Response	%
Non-executive Directors (NED)	150	40	27
Independent Audit Professionals (IAP)	70	33	47
Accountants (ACC)	125	45	36
Government Policy Makers (GPM)	80	44	55
Government Audit & Tax Officers (GATO)	100	62	62
Academics (ACD)	40	29	73
Investors (INV)	100	24	24
Total	**665**	**277**	**42**

One of the major problems of a questionnaire survey is non-response bias. Non-responsiveness can be a serious problem if the sample size is not large enough to allow for non-responses. More specifically, non-response bias can arise if respondents differ systematically from non-respondents (Fox et al., 1998). The non-responses can occur due to either partial completion of the questionnaire or not responding to the questionnaire. In this study two approaches are adopted to address this issue. First, in the questionnaire design stage, an attempt is made to maintain the simplicity and appearance of the questionnaire. Secondly, follow-up procedures such as follow-up by telephone and mail are adopted to minimise non-responses.

Table 6.2 Non-response Bias by Category of Variables

Category of Variables	Significant	Not Significant	Total Questions
Important Components of Corporate Governance	0	11	11
Performance Impact of Corporate governance	1	7	8
Present Status of Corporate Governance	1	8	9
Major Issues of Corporate Governance	0	11	11
Corporate Governance Strategies	1	5	6
Corporate Governance Practices to be Improved	2	12	14
Key Players and Promoters	0	10	10
Total	**5**	**64**	**69**

Despite the conscious efforts taken to minimise non-responses, they amounted to 58 per cent of the sample in the study. Even though this rate could be considered low when compared to non-response rate of some studies (Ho, 2005, Nam and Nam 2004), a test is carried out to determine whether the results are representative of the population. Non-response bias is evaluated by comparing the differences in responses between early respondents and late respondents of the survey (Innes and Mitchell, 1995). Thus, a sample of 105 questionnaires received within a week of distributing the questionnaire is compared with the 33 questionnaires received after sending reminders. In order to find out whether there is a significant difference between the two samples, the independent

sample t-test for mean difference was carried out in respect of each variable (refer Appendix 9). The results of the test are summarized in Table 6.2.

The information in Table 6.2 shows that there are no significant differences in the mean scores of variables between the two sets of responses in relation to three categories of variables. In case of other categories, the mean differences vary only for five variables out of sixty nine. These results suggest that there is no non-responding bias in the survey. This further suggests that the responses in this study can be regarded as a representative sample of the population.

6.3 Profile of Respondents

The questionnaires are administered amongst seven categories of stakeholders who are either directly or indirectly involved in policy formulation and implementation of corporate governance of Sri Lankan listed companies. To collect respondents' biographical data a number of questions were included in the questionnaire. In order to limit the length of the questionnaire, this section is confined to five questions which are focused on important characteristics such as gender, educational and professional qualifications, work experience, and shareholdings of the respondents.

6.3.1 Educational Qualifications and Gender

As the potential respondents of the survey includes important stakeholder groups who could either directly or indirectly involve in policy formulation, implementation or monitoring of corporate governance, the educational background of the majority of them is expected to be high. The respondents are asked to indicate their highest educational qualification by ticking one of the six options given in the questionnaire. The responses to this question are summarized in the first section of the Table 6.3.

As shown in the Table 6.3, over 85 per cent of respondents received tertiary education indicating that they possess an ability to make independent judgments on the issues addressed in this study. As expected all academics and government tax and audit officers have tertiary education as it is a requirement of these professions. These results indicate that the level of education amongst investors and non-executive directors selected for this study is reasonably high, despite there being no formal educational prerequisite for these roles.

Table 6.3 Educational Qualifications and Gender

Highest Educational Qualifications	NED	IAP	ACC	GPM	GATO	ACD	INV	ALL
School Level	17.5	39.4	6.7	4.5	0.0	0.0	8.3	10.5
Diploma	10.0	0.0	8.9	6.8	0.0	0.0	8.3	4.7
Bachelor's Degree	37.5	54.5	68.9	34.1	54.8	34.5	37.5	46.9
Post Gradate Diploma	5.0	3.0	2.2	11.4	17.7	0.0	12.5	8.2
Master's Degree	30.0	3.0	13.3	43.2	27.4	37.9	33.3	26.7
Doctoral Degree	0.0	0.0	0.0	0.0	0.0	27.6	0.0	3.1
Total (%)	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**
Professional Qualifications								
None	15.0	0.0	15.6	25.0	38.7	34.5	4.2	21.7
ICASL / CIMA/ACCA Parts	12.5	12.1	13.3	18.2	38.7	27.6	33.3	22.4
Member (ICASL/CIMA / ACCA)	47.5	81.8	60.0	22.7	9.7	20.7	45.8	38.3
Attorney at law	5.0	0.0	2.2	13.6	1.6	3.4	8.3	4.7
Other	20.0	6.1	8.9	20.5	11.3	13.8	8.3	13.0
Total (%)	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**
Gender								
Male	72.5	57.6	51.1	38.6	56.5	44.8	79.2	56.0
Female	27.5	42.4	48.9	61.4	43.5	55.2	20.8	44.0
Total (%)	100	100	100	100	100	100	100	100
Total Respondents	**40**	**33**	**45**	**44**	**62**	**29**	**24**	**277**

Notes: NED – Non-executive Directors; IAP – Independent Audit Professionals; ACC - Accountants; GPM – Government Policy Makers; GATO - Government Audit and Tax Officers; ACD - Academics; INV – Investors; ICASL – Institute of Chartered Accountants of Sri Lanka; CIMA – Chartered Institute of Management Accountants ; ACCA - Association of Chartered Certified Accountants

In addition to educational qualifications, respondents are also asked to provide their professional qualifications. As it is expected that an accounting qualification facilitates understanding of corporate governance, information on accounting professional qualifications is given prominence in the questionnaire. The results of respondents' professional qualifications are summarized in Table 6.3. The results show that 38 per cent of respondents are professionally qualified accountants. It further shows that 22 per cent of respondents have partially completed accounting professional examinations. Since accounting knowledge is also required for the professions of IAP, ACC and GPM categories, the results are as high as expected for these groups in the sample. Similarly, because academic respondents are selected from the academics in commerce and management faculties, respondents have a high rate of professional qualifications. Overall 80 per cent of respondents have some kind of professional qualification indicating the selected sample is adequately equipped with relevant skills and qualifications to the perception survey conducted.

It is interesting to note that the selected sample is evenly balanced in terms of gender. Overall 56 per cent respondents are males. However, the GPM category, which

represents the staff grade employees of the SEC, Treasury and Central Bank of Sri Lanka, represents 61 per cent of females, suggesting fair recruitment policies adopted by government organizations. However, the NED and INV categories are dominated by males. Other categories show balanced gender distribution indicating the perception survey is free from gender bias.

6.3.2 Work Experience and Company Directorship Experience

In order to gain understanding of the work experience of respondents, they are asked to indicate how long they have been working in their present profession. The results are summarized in Table 6.4.

Table 6.4 Work Experience and Company Directorship Experience

	NED	IAP	ACC	GPM	GATO	ACD	INV	ALL
Work Experience								
Less than one year	0.0	0.0	15.6	11.4	1.6	20.7	4.2	7.2
1 – 5 years	27.5	39.4	31.1	40.9	71.0	31.0	16.7	40.8
5 – 10 years	0.0	45.5	35.6	22.7	6.5	13.8	25.0	19.9
10 – 15 years	10.0	6.1	6.7	6.8	3.2	10.3	16.7	7.6
15 - 20 years	12.5	6.1	4.4	11.4	6.5	17.2	4.2	8.7
Over 20 years	50.0	3.0	6.7	6.8	11.3	6.9	33.3	15.9
Total (%)	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**
Experience as a Director								
Yes	100	6.1	2.2	15.9	0.0	0.0	20.8	19.9
No	0.0	93.9	97.8	84.1	100.0	100.0	79.2	80.1
Total (%)	100	100	100	100	100	100	100	100
Total Respondents	**40**	**33**	**45**	**44**	**62**	**29**	**24**	**277**

Notes: NED – Non-executive Directors; IAP – Independent Audit Professionals; ACC - Accountants; GPM – Government Policy Makers; GATO - Government Audit and Tax Officers; ACD - Academics; INV - Investors

Overall 52 per cent of respondents have over five years working experience while 32 per cent of overall respondents have over 10 years working experience. The government audit and tax officer group comprises the least experience of professionals as 71 per cent of them have less than five years working experience. However, all respondents of this group have tertiary education with 45 per cent of them having post graduate qualifications (refer Table 6.3). The NED group represents the persons with more experience. In this group, over 72 per cent of respondents have more than 10 years of experience. 50 per cent of NEDs have over 20 years working experience, compared to IAPs who have only 3 per cent of the group with over 20 years experience. Overall only 7.2 per cent of respondents have less than one year of working experience. Thus, it is inferred that the sample consists of young and experienced professionals.

Furthermore, with a view of understanding respondents' active involvement in corporate governance activities, they are asked whether they have experience in serving as a director of a public limited company. This question is important for all the groups except NED as it indicates their experience as a director of a company. While there is no one in the GATO and ACD groups with directorship experience, 20.8 per cent of the INV group has experience as a director of a company. The GPM group also has 15.9% of respondents with company directorship experience. Overall, over 19 per cent of respondents have company directorship experience indicating they have immediate experience in implementing corporate governance practices.

6.3.3 Shareholdings

It is assumed that share ownership creates interest amongst investors in a company's affairs, especially an interest in their performance and the factors that influence performance, including corporate governance. Hence information about respondents' shareholdings is also gathered through the questionnaire. The purpose of this question is to determine the number of companies the respondents have invested in. The results are summarized in Table 6.5.

Table 6.5 Share Holdings of the Respondents

Share Holdings	NED	IAP	ACC	GPM	GATO	ACD	INV	ALL
None	30.0	72.7	64.4	72.7	67.7	65.5	0.0	57.0
One company	0.0	15.2	15.6	15.9	14.5	17.2	0.0	11.9
2 – 5 companies	35.0	12.1	20.0	11.4	17.7	17.2	0.0	17.3
6 – 10 companies	17.5	0.0	0.0	0.0	0.0	0.0	62.5	7.9
11 - 20 companies	5.0	0.0	0.0	0.0	0.0	0.0	12.5	1.8
Over 20 companies	12.5	0.0	0.0	0.0	0.0	0.0	25.0	4.0
Total (%)	100	100	100	100	100	100	100	100
Total Respondents	**40**	**33**	**45**	**44**	**62**	**29**	**24**	**277**

Notes: NED – Non-executive Directors; IAP – Independent Audit Professionals; ACC - Accountants; GPM – Government Policy Makers; GATO - Government Audit and Tax Officers; ACD - Academics; INV - Investors

As shown in the Table 6.5, 43 per cent of the respondents own shares in one or more companies with 13.7 per cent of them investing in more than 5 companies. The GPM and IAP groups have shown least interest in investing in shares as over 72 per cent of respondents in these groups have no investment in shares. All respondents of the INV group have invested in over five companies, while 25 per cent have invested in more than 20 companies. NED group have over 70 per cent of respondents with share investments in more than two companies.

Overall, the demographics of the respondents show they are well qualified in terms of educational and professional qualifications, work experience, and an interest in investing in company shares. These traits suggest the respondents are able to make independent judgments regarding the corporate governance issues addressed in the survey.

6.4 Analysis of Survey Results

This section provides an analysis of respondents' perceptions of various aspects of corporate governance in Sri Lanka. The study uses a questionnaire of 69 items on a 5-point Likert scale to collect primary information from seven stakeholder groups. As indicated in Section 4.6.3 seven aspects of corporate governance surveyed are: important components of corporate governance; firm performance implications of corporate governance; the present status of corporate governance; major issues of corporate governance; corporate governance strategies; corporate governance practices needing improvement; and key players and promoters. The average score of each item and the agreed and disagreed percentages are separately analysed and reported under each aspect. Both the answers rated 4 and 5 are considered 'agreed' while both the answers rated 1 and 2 are considered to be 'disagreed', in ascertaining agreed and disagreed percentages. The Kruskal-Wallis test is carried out for all 69 items listed in the questionnaire to find out whether there are significant differences among stakeholder groups with regard to governance issues addressed in the survey.

6.4.1 Important Components of a Corporate Governance System

The corporate governance system of a country is embedded in its unique historical, cultural, legal and economic environment. As a result different governance systems with different governance practices emerge across the world (refer Section 2.4). With the globalisation of the marketplace the quality of a corporate governance system becomes a crucial factor for corporate survival. As referred in Section 2.4, Weimber and Pape (1999) undertook a comprehensive overview of governance systems which define as "a more or less country specific framework of legal, institutional and cultural factors, shaping the patterns of influence that stakeholders exert on managerial decision making"(p.152). The main characteristics and the importance given to various corporate governance components differ across the different corporate governance models. As

referred to in the Section 2.4.3 emerging markets' systems consist of characteristics of both a market-oriented and a network-oriented system.

In order to understand the importance given to various components of the Sri Lankan corporate governance system, the respondents were asked to indicate whether they agree with the given component as a part of the corporate governance system of the country. The summarised results of the responses to this question are given in Table 6.6. The results denote the quantum of importance the various categories of respondents have given to the components of the corporate governance system. Eleven components are addressed in this question of which the detailed findings of each are analysed. Furthermore, in order to examine whether there would be any significant difference between the seven stakeholder groups with regard to the importance that they have given to each component of corporate governance, the Kruskal-Wallis test is carried out and the test results are also given in Table 6.6, along with the chi-square (X^2) and asymptotic significant (*p*) values of this test.

All categories of respondents, with the exception of GATO, rate highly the importance of companies' internal management structure and their board to effective corporate governance, with average scores ranging from 4.04 to 4.25. The board is considered to be of central importance to a corporate governance framework (Allen et al., 2004, Bonn et al., 2004.). Therefore its commitment is vital. However, in all categories a small percentage of respondents (ranging from 3% to 12%) do not regard the board an important component. Such a view of these respondents is surprising given that they are highly informed in terms of their qualifications and work experience.

The groups ACC (4.18), GPM (4.21), ACD (4.14) and INV (4.00) indicate that where companies' internal management regulations and policies are important for corporate governance. However, groups NED and IAP are of the opinion that this factor is less important than the internal management structure and the board.

The judiciary system of Sri Lanka facilitates legal interpretation and law enforcement to ensure the functioning of corporate governance. An increasing number of high-profile corporate scandals globally require rigorous corporate legislation and enforcement. However, most of the respondents did not place great significance on the

judiciary being a relevant component of a corporate governance system, with an average survey score of 3.63 being given, the lowest of the eleven corporate governance component surveyed. When compared with the average survey score for the financial reporting framework of 4.19 it is clear that the respondents perceive financial aspects rather than legislative aspects are more crucial for a sound corporate governance practice in Sri Lanka.

Table 6.6 Components of Corporate Governance System

Components		NED	IAP	ACC	GPM	GATO	ACD	INV	ALL	X^2	*P*
Companies' internal management structure and the board	Av	4.05	4.09	4.18	3.93	3.57	4.25	4.04	3.97	19.34	0.00
	A	74%	78%	76%	72%	50%	89%	65%	70%		
	D	11%	3%	4%	12%	8%	4%	9%	7%		
Companies' internal management regulations, policies and procedures	Av	3.79	3.81	4.18	4.21	3.82	4.14	4.00	3.99	9.17	0.16
	A	58%	69%	73%	72%	72%	82%	65%	70%		
	D	13%	9%	4%	9%	11%	4%	9%	9%		
Judiciary system of the country	Av	3.29	3.63	3.98	3.14	3.90	3.61	3.77	3.63	16.69	0.01
	A	63%	56%	69%	47%	66%	61%	68%	61%		
	D	24%	13%	11%	21%	10%	18%	14%	15%		
Regulatory framework including monitoring institutions of the country	Av	4.05	4.10	4.27	4.12	3.66	4.04	4.35	4.04	16.45	0.01
	A	79%	84%	82%	77%	62%	79%	87%	77%		
	D	11%	3%	2%	9%	10%	7%	0%	7%		
Financial reporting framework of the country	Av	4.23	4.09	4.41	4.19	4.00	4.15	4.39	4.19	10.52	0.10
	A	77%	75%	86%	84%	74%	89%	87%	81%		
	D	3%	9%	2%	5%	2%	7%	0%	4%		
Ownership structure of the companies	Av	3.61	3.69	3.95	3.79	3.13	3.82	4.22	3.67	21.41	0.00
	A	55%	63%	70%	58%	48%	64%	70%	60%		
	D	5%	6%	14%	16%	24%	14%	4%	14%		
Code of best practices of corporate governance	Av	4.39	4.38	4.50	4.43	3.82	4.32	4.74	4.31	23.75	0.00
	A	89%	88%	91%	89%	64%	86%	91%	83%		
	D	3%	3%	2%	5%	11%	7%	0%	5%		
Corporate culture and practices	Av	4.03	4.06	4.09	3.70	3.53	3.79	4.04	3.85	20.40	0.00
	A	76%	75%	78%	63%	60%	71%	78%	70%		
	D	8%	3%	7%	7%	13%	11%	9%	8%		
Relationship among core stakeholders	Av	3.76	3.59	3.91	3.72	3.60	4.00	4.00	3.77	8.20	0.22
	A	61%	59%	67%	51%	50%	79%	65%	60%		
	D	8%	9%	4%	5%	5%	7%	4%	6%		
Code of conduct and ethics applicable in business	Av	4.37	4.28	4.29	4.16	3.53	4.07	4.30	4.08	28.37	0.00
	A	82%	91%	87%	74%	69%	82%	91%	80%		
	D	0%	3%	2%	5%	15%	7%	9%	6%		
Culture and value system of the society	Av	3.67	3.66	3.71	3.72	3.76	3.39	3.73	3.68	2.64	0.85
	A	59%	63%	62%	60%	65%	61%	64%	62%		
	D	13%	6%	9%	16%	16%	21%	14%	14%		

Notes:
1) Av – Average; A – Agree; D – Disagree
2) NED – Non-executive Directors; IAP – Independent Audit Professionals; ACC – Accountants; GPM – Government Policy Makers; GATO – Government Audit and Tax Officers; ACD – Academics; INV – Investors

Monitoring institutions are considered vital for good corporate governance by all responding categories, this aspect receiving an average score of 4.04. It is interesting to note that the GATO group rated the importance of monitoring institutions lowest of the groups, indicating an average score of 3.66. Similarly, the majority of respondents believe that the financial reporting framework of the company is also a significant component of the corporate governance system, indicating an average sample rating of 4.19.

As evident from the Sections 5.5.2 and 5.5.3 of the study, the ownership structure of Sri Lankan companies is important to the corporate governance system. It is obvious that corporate governance effectiveness is weaker in companies with family ownership or concentrated ownership. However, most of the respondents do not consider ownership structure as an important component influencing corporate governance effectiveness. However, INV group strongly agrees that the ownership structure is important, showing an average score of 4.22. Similarly with respect to the survey response regarding the importance of the judiciary system, an overall average score of 3.67 illustrates the disagreement in including this component in the governance system.

The 'Code of Best Practices of Corporate Governance' and the Code of Conduct and Ethics' applicable in business are considered essential components of corporate governance by all groups, which indicate an overall average of 4.31 (highest of the sample of all questions) and 4.08 respectively. The GATO group ranked this score 3.82, indicating they place least importance on these codes to the governance system. A notable point is that in the NED category, almost all respondents indicate that codes of conduct and ethical values are a crucial factor in good corporate governance.

The exception of three stakeholder groups (GPM, GATO and ACD) the other four groups agree that 'corporate culture and practices' is a vital component of a corporate governance system. The NED, IAP, ACC and INV groups show a tendency in believing the preservation of corporate culture and practices are important for better corporate governance. However, most of the respondents are of the view that culture and value systems of society are not important for better corporate governance. A similar opinion is expressed with regard to the relationship among core stakeholders as

indicated by the lower overall average of 3.77. However, this is considered as significant by ACD and INV groups, contradicting with the views of other groups.

In order to examine whether there is a significant difference among stakeholders in relation to the perceived importance they give to various components of a corporate governance system, the Kruskal-Wallis test is performed. The significant differences are found between stakeholder groups in respect of seven of the eleven items listed in the questionnaire. All significant differences are significant at the one per cent level, suggesting the importance given to these items varies significantly across the seven stakeholder groups. Accordingly it can be concluded that there is no agreement amongst stakeholders in respect of the importance given to each component of corporate governance system.

6.4.2 Implications for Firm Performance of Corporate Governance

Better corporate governance is supposed to lead to better corporate performance, by preventing expropriation by controlling shareholders, and ensuring better decision making (Klapper and Love, 2002, Brown and Gorgens, 2009). Investors are willing to invest more in better-governed companies because of the lower cost of capital, contributing to better share performance for those companies. As evident in the Section 5.6, compliance to corporate governance best practices has a significant positive relationship with the financial performance of Sri Lankan companies. However, how stakeholders perceive performance implications of corporate governance is a central issue that needs to be addressed in formulating and implementing corporate governance practices. Thus, in order to understand the stakeholders' perception regarding performance implications of corporate governance, the respondents are asked to indicate whether better corporate governance would improve various aspects of company performance. The summarized results of the responses to this question are given in Table 6.7. Eight significant implications have been considered in this area and the findings are illustrated below.

The majority of respondents across all categories have answered positively with an average of 4.17 to the question whether good corporate governance improves financial performance. When comparing results among each category, ACD and almost all INV placed more emphasis on this fact with averages of 4.31 and 4.45. These

responses are consistent with the findings of the test results given in the Section 5.6 where it is found that better compliance to corporate governance best practices has a significant positive relationship with the financial performance of Sri Lankan companies. However, an average minority of 4% of respondents disagree on this issue.

Table 6.7 Performance Implications of Corporate Governance

Performance Implications		NED	IAP	ACC	GPM	GATO	ACD	INV	ALL	X^2	*P*
Improve financial performance	Av	4.03	4.06	4.07	4.34	4.10	4.31	4.45	4.17	8.07	0.23
	A	79%	79%	80%	84%	79%	90%	91%	82%		
	D	8%	3%	9%	2%	3%	3%	0%	4%		
Improve ability to generate equity capital	Av	4.50	3.67	3.91	4.05	3.54	4.21	4.48	3.99	47.08	0.00
	A	83%	70%	64%	72%	64%	90%	78%	73%		
	D	8%	9%	2%	7%	8%	3%	0%	6%		
Improve access to new capital	Av	4.58	3.97	4.02	4.02	3.70	4.10	4.48	4.07	32.10	0.00
	A	83%	76%	70%	74%	59%	86%	78%	73%		
	D	0%	6%	5%	2%	8%	3%	0%	4%		
Increase market value of shares	Av	4.20	3.82	4.16	4.05	3.87	4.07	4.48	4.06	14.60	0.02
	A	68%	73%	84%	74%	69%	83%	81%	75%		
	D	5%	9%	4%	2%	5%	10%	5%	6%		
Reduce share price volatility	Av	3.38	3.41	3.70	3.56	3.26	3.59	3.43	3.46	9.75	0.14
	A	48%	41%	66%	49%	31%	59%	43%	47%		
	D	18%	9%	11%	7%	13%	7%	17%	12%		
Reduce political or regulatory intervention	Av	3.33	3.24	3.53	3.88	3.79	3.79	3.52	3.61	11.46	0.08
	A	55%	36%	51%	63%	64%	69%	61%	57%		
	D	23%	15%	18%	9%	11%	10%	9%	14%		
Reduce cost of capital	Av	3.46	3.06	3.49	3.56	3.69	3.57	3.35	3.49	11.15	0.08
	A	51%	21%	49%	47%	61%	54%	52%	49%		
	D	18%	15%	13%	16%	5%	11%	30%	14%		
Improve corporate social responsibility	Av	4.35	4.24	4.20	3.95	4.24	4.41	4.52	4.25	10.37	0.11
	A	85%	85%	73%	74%	85%	86%	96%	83%		
	D	3%	3%	2%	7%	6%	0%	4%	4%		

Notes:
1) Av – Average; A – Agree; D – Disagree
2) NED – Non-executive Directors; IAP – Independent Audit Professionals; ACC – Accountants; GPM – Government Policy Makers; GATO – Government Audit and Tax Officers; ACD – Academics; INV – Investors

As to the question whether sound corporate governance improves the ability to generate equity capital, the groups' average response is 3.99. Although it is not as positive as the perception that good corporate governance improves financial performance, the majority of respondents agree on this issue, with only 6 per cent disagreeing on average. The categories of NED, GPM, ACD and almost all INV support this fact with a stronger agreement. A similar behaviour has been observed with regard to the raising of new capital. The stakeholders responded with an overall average of 4.07 to the question whether sound corporate governance improves access to new

capital. It is again noted that the entirety of NED and INV agreed fully in favour with this statement with averages of 4.58 (highest of the sample) and 4.48 respectively. Even though corporate governance is considered to be one of the key aspects that lenders and investors measure to assess the overall soundness of company management, on average 4 per cent of the respondents are of a contradictory view.

The groups' response to the statement that 'market value of shares increase because of sound corporate governance' is positive, with an overall average of 4.06. Those who do not significantly support this fact are the IAP and GATO with averages of 3.82 and 3.87 while INV are the most supporting category with an average of 4.48.

However, the least agreed performance measure is that 'good corporate governance manages to reduce share price volatility'. Those who agree on this point fell below 50% of the total respondents with the lowest overall average of 3.46. It is noted that NED and INV groups who hold share investments in a larger number of companies (refer Table 6.5) show higher levels of disagreement. These perceptions are consistent with the findings of the test given in Section 5.6. This examination fails to find any positive impact of corporate governance compliance on market performance, suggesting the existence of abnormal price behaviour in the Sri Lankan stock market.

Poor corporate governance is one of the main sources of corruption and corruptive relationships between business and political circles (Nam and Nam 2004). It can be inferred that better corporate governance reduces political intervention and corruption. However, for the statement 'sound corporate governance reduces political or regulatory intervention', most respondents disagree with an overall average of 3.61, indicating political influence cannot be avoided in the Sri Lankan context even with sound corporate governance. It is interesting to note that NED shows the highest level of disagreement at 23 per cent. The validity of their claim is supported by their direct experience in corporate governance.

Convention assumes investors and lenders are keen on investing in firms with good governance due to the fact that sound corporate governance reduces costs of capital. However, the majority of respondents disagree with the proposition that the cost of capital reduces as a result of sound corporate governance. Most of the

respondents agree with the claim that good corporate governance improves corporate social responsibility. All the groups have responded positively with an overall average of 4.25. This is the highest average indicate that a vast majority agree that corporate governance improves corporate social responsibility.

The responses are tested using the Kruskal-Wallis test to see whether there is a significant difference between the opinions of different groups with regard to the performance implications of corporate governance. Significant differences are found between stakeholder groups in respect of three of the eight items listed in the questionnaire. The significant differences at the one per cent level are noticed in relation to the propositions that: first, corporate governance improves the ability to generate equity; and, secondly corporate governance improves the ability to generate new capital. This suggests that stakeholders' opinions on these items vary significantly across groups. Thirdly, opinions are significantly different regarding the perceived impact of corporate governance on market price performance. Apart from these three items, opinion differences of other items are not significant suggesting different stakeholder groups are in agreement in respect of their opinions on these items.

6.4.3 Status of Corporate Governance

The recognition of the weaknesses of the prevailing Sri Lankan corporate governance system is essential in formulating governance reforms. In this respect, it is important to discover how stakeholders perceive the present status of corporate governance. Thus, in order to understand the stakeholders' perceptions, the respondents are asked to indicate their opinion about various aspects of the prevailing corporate governance system of the country. The summarized results of the responses to this question are given in Table 6.8.

The respondents are asked to express their views regarding the present positioning of Sri Lanka's corporate governance system as a whole, compared to: first that of a developed country; and secondly, to that of an Asian country. The majority of respondents disagree with the statement 'the standard of corporate governance in Sri Lanka is comparable to that of a developed country'. The responses are significantly low with an overall lowest average of 2.33, indicating a large majority believe that Sri Lanka's corporate governance system as a whole requires considerable improvement.

The respondents across all categories have clear opinions on this issue, as reflected by their overall disagreement rate of over 50 per cent. In analysing the disagreeing respondents across categories, it can be seen that NED are at the top with 59% followed by GATO, ACD and INV with percentages of 53, 55 and 52 respectively. The results are slightly better to the next question of whether Sri Lanka is comparable to that of Asian countries, achieving an overall average of 3.29 agreements. Over 50 per cent of respondents in the IAP and GPM groups believe that it is comparable, but this is less obvious in respect of other categories.

Table 6.8 Status of Corporate Governance in Sri Lanka

Status of Corporate Governance		NED	IAP	ACC	GPM	GATO	ACD	INV	ALL	X^2	*P*
Standard of CG in Sri Lanka is comparable to CG of a developed country.	Av	2.05	2.48	2.49	2.44	2.26	2.17	2.43	2.33	5.02	0.54
	A	13%	9%	16%	9%	11%	10%	30%	13%		
	D	59%	39%	47%	42%	53%	55%	52%	50%		
Standard of CG in Sri Lanka is comparable to that of Asian countries.	Av	3.18	3.52	3.27	3.37	3.15	3.31	3.43	3.29	5.82	0.44
	A	28%	55%	38%	51%	40%	41%	39%	42%		
	D	21%	6%	16%	12%	21%	17%	9%	15%		
The existing CG regulations are adequate to ensure good CG	Av	2.38	2.55	2.42	2.47	2.79	2.39	2.43	2.52	5.20	0.52
	A	20%	21%	22%	19%	29%	14%	17%	22%		
	D	53%	39%	51%	40%	32%	46%	48%	43%		
The existing CG rules are effectively implemented by most of the firms	Av	2.46	2.45	2.47	2.47	2.63	2.63	2.39	2.51	2.45	0.87
	A	13%	9%	11%	5%	17%	15%	13%	12%		
	D	62%	58%	49%	44%	47%	48%	52%	51%		
Regulatory monitoring of CG compliance is adequate.	Av	2.85	2.45	2.31	2.44	2.71	2.00	2.30	2.48	13.16	0.04
	A	18%	12%	11%	7%	15%	14%	13%	13%		
	D	49%	52%	62%	58%	40%	59%	43%	51%		
The CSE should have introduced more rigorous CG rules.	Av	2.79	3.55	3.36	3.81	3.44	4.00	4.17	3.53	27.83	0.00
	A	38%	58%	42%	49%	41%	62%	70%	49%		
	D	31%	9%	20%	5%	13%	7%	9%	14%		
Most listed companies have taken measures to strengthen their CG.	Av	3.51	3.36	3.24	3.28	3.27	3.28	2.70	3.26	6.08	0.41
	A	36%	36%	36%	35%	42%	38%	26%	36%		
	D	15%	3%	13%	7%	13%	10%	30%	13%		
Most listed companies could have done more to strengthen their CG.	Av	3.46	3.70	3.91	4.32	3.70	3.79	4.30	3.86	27.44	0.00
	A	67%	61%	72%	73%	62%	66%	74%	67%		
	D	13%	6%	9%	5%	8%	3%	9%	8%		
The interests of minority investors are adequately protected	Av	2.85	2.61	2.58	2.40	2.51	2.34	2.04	2.51	6.84	0.34
	A	15%	6%	18%	17%	23%	10%	22%	16%		
	D	43%	42%	49%	40%	39%	45%	61%	44%		

Notes:
1) Av – Average; A – Agree; D – Disagree
2) NED – Non-executive Directors; IAP – Independent Audit Professionals; ACC – Accountants; GPM – Government Policy Makers; GATO – Government Audit and Tax Officers; ACD – Academics; INV – Investors

The respondents' opinion regarding the adequacy and implementation efficiency of exiting corporate governance regulations are the next considered aspects of corporate governance. The disagreement is clearly visible across all categories

regarding the perceived adequacy of existing corporate governance regulations to ensure good corporate governance, scoring a low overall average of 2.52. Most of the respondents are of the view that the existing regulations are not enough to safeguard the good corporate governance, suggesting policy makers fail in their duties to formulate adequate governance regulations. The respondents in NED, ACC and INV groups show more disagreement than other groups, with disagreement rates of 53 percent, 51 percent, and 48 percent respectively. The responses for the proposition that there is 'effective implementation of existing regulations' show even more disagreement. The overall average for agreement with the statement was 2.51. NED and IAP groups indicate stronger disagreement than the overall average, as reflected by their disagreement rates of 62 percent and 58 percent respectively. The overall disagreement rate over 51 percent show a majority of respondents require companies to pay more attention in their implementation of existing corporate governance regulations.

The statement 'the regulatory monitoring of corporate governance compliance is adequate' has received low agreement, with responses being an overall average of 2.4, indicating most of the respondents require regulators to increase their monitoring activities. The disagreement is clearly visible among the ACC, ACD and GPM groups, who recorded disagreement rates of 62 per cent, 59 per cent and 58 per cent respectively. The overall disagreement rate of 51 per cent is consistent with the disagreement expressed in relation to effective implementation of regulations. Thus, respondents are of the view that the regulators need to formulate mechanisms to safeguard effective monitoring, as companies do not implement the regulations effectively. Furthermore, there was a positive response from those surveyed on the introduction of more rigorous corporate governance rules by the CSE as indicated by an overall average of 3.53. However, the NED group disagreed with the introduction of rigorous corporate governance rules. The lack of implementation of corporate governance rules and regulations to date, and resistance to the introduction of new rules, can be interpreted as a negative attitude and commitment by company directors towards corporate governance regulations.

When asked whether most listed companies could have done more to strengthen their corporate governance, respondents agreed recording an overall average of 3.86, or over 60 per cent. The strongest group agreeing with the statement is INV with an

agreement rate of 74 per cent. This is a clear message that companies need to improve their internal corporate governance mechanisms as the majority of stakeholders are not happy with the present form of corporate governance implemented by respective companies. Furthermore, the respondents have expressed strong negative views in relation to the adequacy of protection of minority shareholders' interests, with an overall average of 2.51. The overall disagreement rate is over 44 per cent. It is interesting to note that the disagreement rate of the INV group is over 61 per cent, since they have direct experience of the protection of minority shareholders' rights. This further confirms the view that the Sri Lankan companies could do more in strengthening their corporate governance.

The Kruskal-Wallis test results show that the differences between stakeholder groups are significant only for three of the nine items listed in the question. The significant differences at the one per cent level are noticed in relation to the adequacy of regulatory monitoring and the introduction of more rigorous governance rules. The NED group disagrees with the introduction of new rules resulting in a significant difference from other groups. Furthermore, the item that the companies need to do more in strengthening their corporate governance also shows significant difference. Apart from these three items, opinion differences of other items are not significant suggesting most of the aspects of the present status of Sri Lankan corporate governance are collectively agreed upon by all stakeholder groups.

6.4.4 Identified Issues of Sri Lankan Corporate Governance

Corporate governance provides the structure through which accountability and responsibility to stakeholders can be exercised. Thus, effective board functioning is of paramount importance for sound corporate governance, especially given the aftermath of high-profile corporate scandals in recent years. In order to understand the corporate governance issues faced by Sri Lankan companies, the respondents are given eleven issues and are asked to indicate whether they regard the stated issues are major or minor. Summarized results of their responses are given in Table 6.9.

A majority of the respondents think that there is a significant lack of integrity and ethics amongst top management, as indicated by an overall average response of 4.08. 73 per cent agree that this is a relevant issue in Sri Lankan companies. More than 83 per cent of respondents in the ACD and INV groups agree that this is a significant

issue. No investor surveyed selected this as a minor issue. Furthermore, a lack of transparency is also considered a significant issue by a majority of respondents, scoring an overall average of 4.13, or 73 per cent. However, noticeably respondents in the IAP group do not rate transparency as a major issue while all other groups agree that a lack of transparency is an issue, with an agreement rate of over 70 per cent. In the case of ACD, respondents give virtually no negative responses.

Table 6.9 Issues of Corporate Governance

Issues of Corporate Governance		NED	IAP	ACC	GPM	GATO	ACD	INV	ALL	X^2	*P*
Lack of integrity and ethics among top management	Av	4.21	3.88	4.02	4.02	3.85	4.52	4.48	4.08	18.20	0.01
	Mj	74%	64%	76%	73%	66%	83%	83%	73%		
	Mi	5%	6%	7%	11%	10%	3%	0%	7%		
Lack of transparency in financial reporting	Av	3.79	3.45	3.71	4.27	4.52	4.62	4.52	4.13	73.37	0.00
	Mj	74%	48%	76%	70%	82%	83%	83%	74%		
	Mi	15%	3%	9%	5%	5%	0%	4%	6%		
Insider trading (directors artificially control share prices for personal gain)	Av	3.36	3.67	3.98	4.34	3.80	4.34	4.00	3.91	26.03	0.00
	Mj	59%	61%	66%	75%	49%	76%	61%	63%		
	Mi	15%	9%	9%	5%	8%	3%	13%	9%		
Inadequate protection of minority shareholders' rights	Av	3.59	3.42	3.49	4.14	3.87	4.17	4.13	3.81	25.30	0.00
	Mj	59%	48%	51%	64%	53%	69%	61%	57%		
	Mi	3%	9%	7%	9%	8%	3%	0%	6%		
Conflicts of interest of directors	Av	3.46	3.75	3.73	4.20	3.73	4.28	4.48	3.89	26.04	0.00
	Mj	67%	59%	58%	68%	53%	69%	78%	63%		
	Mi	13%	9%	11%	9%	15%	3%	0%	10%		
Drain off of funds through associate or subsidiary companies	Av	3.68	3.64	3.87	4.41	3.92	4.17	4.30	3.98	26.78	0.00
	Mj	71%	70%	64%	77%	51%	66%	70%	66%		
	Mi	8%	6%	4%	5%	0%	7%	0%	4%		
Independent directors do not exercise true independence in decision making	Av	3.90	3.79	3.84	4.00	3.58	4.00	4.22	3.86	11.11	0.09
	Mj	69%	67%	69%	75%	53%	72%	78%	67%		
	Mi	8%	9%	7%	5%	11%	7%	0%	7%		
Inadequate and inefficient risk management	Av	3.79	4.00	4.11	3.84	3.85	3.69	4.26	3.92	10.93	0.09
	Mj	69%	79%	80%	70%	74%	62%	83%	74%		
	Mi	5%	0%	2%	5%	10%	3%	0%	4%		
Lack of transparency about directors' remuneration	Av	3.46	3.82	3.84	4.32	4.06	4.21	4.26	3.99	28.40	0.00
	Mj	51%	67%	64%	70%	65%	72%	74%	65%		
	Mi	5%	6%	7%	2%	11%	10%	13%	8%		
Lack of proper balance between executive and NEDs in the board	Av	3.44	3.58	3.64	3.52	3.60	3.52	3.96	3.59	5.80	0.45
	Mj	44%	58%	53%	57%	61%	55%	74%	57%		
	Mi	15%	6%	7%	11%	11%	17%	4%	11%		
Ineffective connectivity between board and management	Av	3.51	3.64	3.98	3.55	3.68	3.76	3.57	3.68	7.38	0.29
	Mj	59%	52%	67%	50%	53%	62%	57%	57%		
	Mi	13%	6%	4%	5%	3%	3%	9%	6%		

Notes:
1) Av – Average; Mj – Major Issue; Mi – Minor Issue
2) NED – Non-executive Directors; IAP – Independent Audit Professionals; ACC – Accountants; GPM – Government Policy Makers; GATO – Government Audit and Tax Officers; ACD – Academics; INV – Investors

Concerning insider trading, a majority of respondents consider it as a significant issue, with an overall average response of 3.91, over 50 per cent. The ACD and GPM rank highest in agreeing insider trading is a problem, recording 76 per cent and 75 per cent respectively, and disagreement rates of only 3 per cent and 5 per cent respectively.

Conflicts of interest rated as being a relevant issue with an overall average score of 3.89 and positive response rate of 63 per cent. These scores are almost on par with what respondents scored for the topic insider trading. Once again, responses exceed 50 per cent in all categories, while INV rank 'conflicts of interest' the highest with an average of 4.48, a positive rate of 78 per cent and a nil negative rate.

Respondents were asked to indicate whether they regarded the drain off of funds through associate or subsidiary companies as a key issue for Sri Lankan corporate governance. Respondents indicated that they did perceive this as significant, giving an overall average of 3.98, with 66 per cent agreeing with the statement. Only 4 per cent disagreed, which is the lowest of the sample. Both GATO and INV recorded a nil rate.

The issues of insider trading, conflicts of interest of directors and drain off of funds through associate companies reflect ineffective functioning of a company's board. All these issues are identified as relevant to a lack of confidence placed by stakeholders in the proper functioning of boards of Sri Lankan companies.

Respondents were questioned on their perceptions of whether independent directors exercise true independence in their decision making. This was perceived as a major issue by respondents, with an overall average of 3.86 agreeing that independent directors do not exercise true independence in decision making. On this question, INV recorded the highest average of 4.22, over 78 per cent of respondents in the group. No respondent in INV group considered this a minor issue.

Concerning directors' remunerations, all the categories of respondents except NED agree that there is a lack of transparency. The strength of this opinion is obvious as this is the highest rating amongst all issues. It is interesting to note that the respondents of NED are the least supportive of the notion of the lack of transparency of directors'

remuneration as a problem, recording the lowest average of 3.46. This reflects NED's reluctance to disclose remunerations.

The next issue included in the perception questionnaire is that of whether the respondent thinks a proper balance between executive and non-executive directors on a board is important for good corporate governance. This question received similar responses to the previous question on directors' remuneration, with an overall average of 3.59. All the categories except NED are of the view that a lack of proper balance in the board is a major issue, with over 50 per cent in agreement with the proposition. However, NED rated this issue as minor.

The responses are analysed statistically using the Kruskal-Wallis test to see whether there is a significant difference between the opinions of different groups with regard to the given issues. The significant differences are found in respect of seven of the eleven issues listed in the questionnaire. All significant differences are significant at the one per cent level, indicating there are clear differences among groups' opinions. As most of the given issues are related to board functioning and transparency, it is not surprising therefore that NEDs' opinions are different to the opinion of other groups.

6.4.5 Importance of Different Corporate Governance Strategies

The efficiency of alternative governance structures depends upon the environment within which they operate. Fan (2004) claims that existing theories of corporate governance have not been successful in recognizing the determinants of good corporate governance as it operates in highly complex diverse environments. To improve corporate governance practices, various strategies can be adopted. The improvement of operational efficiency of internal corporate governance mechanisms such as: board functioning; composition; compensation; and, managerial shares ownership is one strategy to promote good corporate governance practices. Also, the development of operational efficiency of external corporate governance mechanisms such as: the market for corporate control; large shareholders; the legal system; creditor protection; and, leverage is another strategy to promote good corporate governance practices. However, their success depends on both various constituent components of a corporate governance system, and the environment within which these components operate. The area which should be given priority in Sri Lanka is an important issue to be

addressed. In order to understand stakeholders' opinions on these issues, respondents were asked to indicate the importance they give to six named corporate governance strategies. The summarized results of their responses are given in Table 6.10.

Table 6.10 Corporate Governance Strategies

Corporate Governance Strategies		NED	IAP	ACC	GPM	GATO	ACD	INV	ALL	X^2	*P*
Making the internal corporate governance mechanisms work better	Av	4.10	4.21	4.24	4.64	4.50	4.31	4.25	4.35	26.06	0.00
	Mi	78%	88%	89%	89%	84%	97%	71%	85%		
	Li	0%	0%	4%	2%	6%	0%	4%	3%		
Making the external corporate governance mechanisms work better	Av	3.54	3.94	4.27	4.64	4.13	4.62	3.96	4.16	50.76	0.00
	Mi	59%	82%	84%	86%	69%	86%	75%	77%		
	Li	10%	3%	2%	0%	8%	0%	8%	5%		
Enhancing the standards of accounting, audit and disclosures	Av	3.97	4.52	4.04	4.79	4.23	4.34	4.21	4.30	36.24	0.00
	Mi	71%	79%	80%	93%	82%	86%	67%	81%		
	Li	0%	0%	2%	0%	5%	3%	4%	2%		
Conducting corporate governance ratings of companies	Av	3.80	3.78	4.18	4.16	3.98	4.03	4.13	4.01	8.73	0.19
	Mi	70%	68%	80%	82%	74%	76%	88%	77%		
	Li	5%	16%	5%	2%	2%	3%	0%	4%		
Prohibiting or tightly controlling some types of RPTs	Av	4.00	4.21	4.41	3.95	3.94	3.93	4.13	4.07	14.20	0.03
	Mi	76%	70%	75%	73%	73%	75%	67%	73%		
	Li	3%	9%	2%	11%	6%	4%	8%	6%		
Reducing ownership concentration	Av	3.53	3.55	3.89	3.84	3.56	3.79	3.71	3.69	5.10	0.53
	Mi	53%	58%	64%	66%	49%	66%	58%	58%		
	Li	20%	15%	2%	5%	13%	3%	17%	11%		

Notes:
1) Av – Average; Mi – More Important; Li – Less Important
2) NED – Non-executive Directors; IAP – Independent Audit Professionals; ACC – Accountants; GPM – Government Policy Makers; GATO – Government Audit and Tax Officers; ACD – Academics; INV – Investors

The strategy of 'making internal corporate governance mechanisms work better' is considered important by all groups, as is demonstrated by an overall score of 4.35. 85 per cent of respondents consider this as a very important strategy, and in the ACD group over 97 per cent consider it as an important strategy. Overall, only 3 per cent of respondents consider 'making internal corporate governance mechanisms work better' as a less important strategy. In the NED, IAP and ACD groups, no one considers it as a less important strategy.

A similar response is observed in relation to the question about external corporate governance mechanisms. Overall 77 per cent of respondents consider 'making the external corporate governance mechanisms work better' as an important strategy to achieve improved corporate governance. . GPM strongly view this as an important strategy, recording a score of 4.64. The GPM and ACD have completely eliminated it as being less important, giving a rating of zero. This opinion indicates both internal and

external governance mechanisms are perceived as important for Sri Lanka to promote good governance practices.

All respondents have a strong positive attitude that enhancing the standards of accounting, audit and disclosures is a strategy that will improve corporate governance. This is reflected in response rates to the statement ranging from a low of 67 per cent by INV to 93 per cent by GPM. An overall average of 4.30 is noted while the respondents who think that it is of less importance are recorded at only 2 per cent. The respondents in NED, IAP and GPM groups have given zero rating for ranking this strategy in the 'less importance' category.

Conducting corporate governance ratings of companies have also been treated as an important strategy by most of the respondents, reflected in an overall average of 4.01. More than 65% of all respondents indicate conducting corporate governance ratings is an important strategy to improving corporate governance, while only 4% express a contradictory view.

Furthermore, the prohibiting or tightly controlling some types of RPTs is also accepted by respondents as an important strategy, scoring an overall average of 4.07, and an acceptance rate of 73 per cent.

However, changes to ownership concentrations are not well accepted by respondents as good strategy to achieve better corporate governance in Sri Lanka. Ownership concentration and the presence of family ownership are common characteristics of Sri Lankan companies (refer Section 5.3.3).

With respect to corporate governance strategies, the Kruskal-Wallis test results found that four of the six strategies surveyed have significant differences between the opinions of different groups. The differences relating to internal governance mechanisms, external governance mechanisms, and accounting & auditing standards are significant at the one per cent level whereas the difference in views relating to the control of RPTs is significant at the five per cent level. These differences are clearly visible between the NED group and the GPM group. The overwhelming majority of government policy makers accepted these strategies as important but acceptance among NED groups is relatively low. The test results show that there is no significant

difference among respondent groups in relation to changes in ownership concentration strategy. This confirms the fact that changes to ownership concentration is not acceptable to stakeholders surveyed in the Sri Lankan context.

6.4.6 Corporate Governance Practices that Need Improvement

In emerging economies, the concern of corporate governance in publicly listed companies is controlling-shareholder expropriation (Claessens and Fan, 2002). The OECD (2004) principles intend to mitigate this kind of major corporate governance problem by recommending good governance practices. These principles promote various good governance practices such as an active board of directors; separation of chairperson and the CEO; significant presence of outside directors; adequate disclosures; independent directors' independence both from management and substantial shareholders. However, whether these practices are capable of mitigating specific problems faced by emerging markets is an important issue to be addressed. Thus, in order to understand whether these practices are capable of enhancing corporate governance in Sri Lanka from the stakeholders' point of view, the respondents are asked to indicate whether the corporate governance of Sri Lankan companies can be improved by adhering to given practices. The respondents' views relevant to these practices are summarized in Table 6.11. A survey was carried out seeking stakeholders' opinions on 14 such practices. Certain similarities are found in responses to some practices. Therefore, the 14 practices have been analysed under three segments, depending on the results received.

Several practices received a higher level of agreement amongst respondents, with an overall average score of over 4.00 for each identified practice. These practices are: improvements in respect of giving the audit committee greater power to investigate financial reporting; full disclosure of RPT's; the same person not holding positions of both CEO and chairman; independent directors being independent of both management and major shareholders; and, the adoption of a code of conduct and ethics for all directors, officers and employees. The majority of respondents across all segments are of the opinion that the adoption of a code of conduct is of paramount importance (average 4.41) to improve the corporate governance in Sri Lanka.

Table 6.11 Corporate Governance Practices that need Improvement

Governance Practices		NED	IAP	ACC	GPM	GATO	ACD	INV	ALL	X^2	*P*
Giving the audit committee greater power to investigate financial reporting		3.87	4.52	4.36	4.70	4.08	3.83	4.42	4.25	39.40	0.00
		68%	79%	76%	89%	77%	69%	79%	77%		
		5%	0%	9%	0%	5%	10%	4%	5%		
Full disclosure of related party transactions		4.50	4.21	4.31	4.34	4.02	4.11	4.46	4.26	9.03	0.17
		95%	82%	78%	84%	71%	82%	88%	82%		
		0%	3%	2%	0%	8%	0%	0%	3%		
Not obtaining audit and non audit services from the same provider		3.73	3.45	4.11	4.30	3.56	3.93	4.25	3.88	26.28	0.00
		70%	67%	76%	75%	44%	62%	67%	64%		
		8%	12%	2%	11%	21%	3%	0%	10%		
The CEO and Chairman positions are not held by the same person		4.10	4.09	3.96	4.40	3.89	4.11	4.42	4.10	11.09	0.09
		80%	79%	67%	88%	68%	79%	83%	76%		
		5%	6%	11%	5%	10%	0%	0%	6%		
Remuneration of EDs are closely tied to performance		3.72	3.52	4.02	4.02	4.13	4.07	4.39	3.98	18.36	0.01
		69%	58%	71%	77%	68%	66%	78%	69%		
		5%	18%	2%	5%	3%	3%	9%	6%		
Key advisory committees are composed entirely of independent directors		3.43	3.58	4.00	4.36	4.10	3.93	4.22	3.96	26.41	0.00
		60%	61%	67%	75%	65%	71%	65%	66%		
		13%	9%	13%	0%	8%	4%	0%	7%		
There should be an age limit for directors		3.68	3.27	3.64	3.36	2.87	3.11	3.22	3.29	15.47	0.02
		48%	42%	60%	45%	32%	39%	43%	44%		
		5%	30%	18%	20%	40%	29%	30%	25%		
Independent directors should make up at least half of the board		3.49	3.64	3.98	3.55	3.47	3.66	3.70	3.63	7.42	0.28
		49%	61%	64%	57%	48%	59%	57%	56%		
		15%	6%	2%	16%	10%	14%	4%	10%		
Independent directors should be independent of both management and major shareholders		4.10	4.21	4.31	4.27	3.94	4.38	4.17	4.17	8.88	0.18
		80%	85%	87%	84%	71%	76%	70%	79%		
		5%	0%	7%	2%	8%	3%	17%	6%		
Full disclosure of the recruitment policy of new directors		3.65	3.91	4.02	4.02	3.84	3.79	3.87	3.88	4.76	0.58
		60%	66%	71%	80%	66%	64%	65%	68%		
		10%	3%	2%	2%	6%	0%	4%	4%		
Full disclosure of the remuneration policy for executive directors		3.33	4.00	4.04	4.14	3.74	4.10	4.75	3.95	42.06	0.00
		50%	72%	71%	68%	61%	59%	92%	66%		
		10%	3%	2%	7%	6%	0%	0%	5%		
The exact remuneration of each director should be disclosed in the annual reports		2.85	3.15	3.51	3.61	3.58	3.72	3.63	3.44	15.67	0.02
		28%	45%	53%	57%	55%	66%	50%	51%		
		43%	27%	22%	16%	16%	7%	13%	21%		
Imposed limitations on the number of directorships held by a director at any one time		3.56	3.64	3.93	4.05	3.49	3.72	4.29	3.77	20.20	0.00
		51%	64%	67%	73%	49%	72%	79%	63%		
		18%	15%	9%	9%	10%	14%	4%	11%		
Adoption of a code of conduct and ethics for all directors, officers and employees		4.41	4.24	4.50	4.55	4.28	4.28	4.71	4.41	9.98	0.13
		87%	85%	89%	89%	79%	83%	100%	86%		
		3%	3%	0%	0%	2%	0%	0%	1%		

Notes:
1) Av – Average; A – Agree; D – Disagree
2) NED – Non-executive Directors; IAP – Independent Audit Professionals; ACC – Accountants; GPM – Government Policy Makers; GATO – Government Audit and Tax Officers; ACD – Academics; INV – Investors

The practices which received an overall average ranking of 3.75 to 4.00 are classified as the next level. These practices are: not obtaining audit and non- audit services from the same provider (3.88); closely tying remuneration of executive directors to performance (3.98); composing key advisory committees entirely of independent directors (3.96); fully disclosing the recruitment and remuneration policies of directors (3.88, 3.95); and, imposing limitations on the number of directorships held by a director at any time (3.77). It is interesting to note that these practices rated low levels of acceptance from the NED group, but rated a higher level of acceptance from the respondents of INV, GPM and ACD groups.

The practices which received overall average ratings of 3.75 or below are categorized as the third group. These practices include: at least half the board comprised of independent directors; disclosing exact remuneration of directors in the annual reports; and, setting an age limit for directors. These practices received the lowest overall averages of 3.63, 3.44 and 3.29 respectively. All these practices also received the lowest level of acceptance from the NED group. Disclosing directors' exact remuneration in the annual reports is rejected by most respondents in NED, recording a disagreement rate of 43 per cent. However, most other groups' acceptance rate of this statement is over 50 per cent.

The Kruskal-Wallis test results found that eight of the fourteen practices have significant differences between the opinions of different groups. All these practices, except one, relate to the second and third categories of practices. In the first category only the practice of giving the audit committee greater power to investigate financial reporting shows a significant difference, which is significant at the one per cent level. Most of the groups agree with this practice with a higher acceptance rate, but the acceptance level of NED and ACD is relatively low. In all other cases, the acceptance level of the NED group is relatively low compared to other groups, resulting in significant differences between groups. However, with the exception of NED there are no major differences among other groups.

6.4.7 Efficiency of Key Players of Corporate Governance in Sri Lanka

The promotion of good corporate governance practices is an outcome of combined activities performed by various institutions and activists in civil society. Various activities relating to corporate governance such as: policy formulation; setting

of codes; enacting rules and regulations; monitoring and enforcement; and, effective implementation are essential devices for good corporate governance. In Sri Lanka, several organizations are involved either directly or indirectly in carrying out these functions. In order to understand the efficiency of these organizations, the respondents are asked to indicate their perception about whether these institutions carry out their role efficiently. The respondents' views are summarized in Table 6.12.

Table 6.12 Key Players of Corporate Governance

Key players and Promoters		NED	IAP	ACC	GPM	GATO	ACD	INV	ALL	X^2	*P*
Securities and Exchange Commission of Sri Lanka	Av	3.33	3.48	3.40	3.57	3.39	3.38	3.04	3.39	5.91	0.43
	A	50%	58%	44%	55%	47%	52%	33%	49%		
	D	18%	6%	9%	11%	16%	10%	29%	14%		
Colombo Stock Exchange	Av	3.35	3.39	3.40	3.51	3.45	3.38	3.21	3.40	1.75	0.94
	A	45%	45%	44%	47%	45%	48%	38%	45%		
	D	13%	6%	7%	7%	8%	7%	21%	9%		
Financial supervisory agencies (e.g. Central Bank)	Av	3.10	3.27	3.38	3.40	3.42	3.31	3.08	3.31	3.52	0.74
	A	46%	39%	40%	51%	52%	41%	33%	45%		
	D	33%	18%	11%	16%	16%	14%	29%	19%		
The Institute of Chartered Accounts of Sri Lanka	Av	3.43	3.67	3.49	3.51	3.58	3.34	3.25	3.49	4.28	0.64
	A	55%	64%	51%	58%	58%	41%	54%	55%		
	D	13%	6%	9%	19%	10%	10%	29%	13%		
Other Professional Accounting Institutions	Av	2.97	3.06	3.02	2.95	3.10	3.18	2.68	3.01	4.69	0.58
	A	30%	27%	29%	23%	31%	25%	27%	28%		
	D	30%	15%	29%	28%	20%	4%	45%	24%		
The judiciary	Av	2.76	2.97	2.96	3.21	3.23	3.07	2.87	3.04	7.18	0.30
	A	24%	24%	22%	35%	35%	38%	30%	30%		
	D	37%	24%	24%	16%	19%	28%	35%	25%		
Sri Lanka Institute of Directors	Av	2.88	2.81	2.76	2.95	2.84	2.93	2.45	2.82	6.25	0.40
	A	33%	13%	18%	16%	16%	14%	14%	18%		
	D	43%	28%	36%	19%	25%	18%	55%	30%		
Outside Directors (Independent and NEDs)	Av	2.92	2.94	2.78	2.90	2.75	2.86	2.57	2.82	5.14	0.53
	A	26%	12%	16%	14%	9%	17%	26%	16%		
	D	26%	15%	36%	21%	25%	28%	57%	28%		
Civil Activists (Investors Association, Minority Shareholder etc)	Av	2.56	2.58	2.42	2.65	2.82	2.66	2.35	2.60	9.71	0.14
	A	8%	12%	11%	5%	18%	10%	13%	11%		
	D	44%	42%	60%	35%	34%	31%	65%	43%		
Financial Press and Other Media	Av	2.62	2.79	2.71	2.86	2.93	2.97	2.54	2.79	6.40	0.38
	A	23%	15%	18%	19%	31%	28%	17%	22%		
	D	46%	33%	42%	33%	34%	28%	58%	38%		

Notes:
1) Av – Average; A – Agree; D – Disagree
2) NED – Non-executive Directors; IAP – Independent Audit Professionals; ACC – Accountants; GPM – Government Policy Makers; GATO – Government Audit and Tax Officers; ACD – Academics; INV – Investors

All the institutions and groups under review receive relatively low scores. No institution or groups received overall average over 4.00 indicating that the perception is that these institutions are not carrying out their role efficiently to satisfy stakeholders'

expectations. However, four of the ten organizations did receive an overall average over 3.30. These institutions are the: SEC; CSE; Financial Supervisory Agencies; and, ICASL. The ICASL is selected by the respondents, with the highest overall average of 3.49, as the most efficient among other institutes which play a role in promoting good corporate governance. Investors deviate slightly from the other groups however, by disagreeing (29 per cent each) more to the role played by SEC and ICASL. A similar view is expressed by NED and INV with regards to financial supervisory agencies, reflected in disagreement rates of 33 per cent and 29 per cent respectively.

The judiciary and professional accounting institutions receive an overall rating average slightly over 3.00. However, their overall averages (3.04 and 3.01respectively) show that the majority of respondents believe these institutions do not carry out their functions efficiently in promoting good governance practices. Judicial enforcement is vital for promoting good governance. However, as shown by an overall disagreement rate of over 25 per cent, the majority of respondents are not satisfied with the judiciary functions. The NED and INV groups show higher levels of dissatisfaction with disagreement rates of 37 per cent and 35 per cent respectively. This evidence indicates the respondents have lost their confidence in the efficiency of judiciary system in Sri Lanka, in its ability to promote good corporate governance practices.

The highest levels of dissatisfaction are observed in relation to the activities of the Sri Lanka Institute of Directors, outside directors, civil activists and the media. The respondents across all groups consider these institutions are highly inefficient as shown by the average scores of 2.82, 2.82, 2.60 and 2.79 respectively. The respondents believe that the activities of the media and civil activists are extremely inefficient. This indicates that there are no active social organizations such as investor associations and free financial media who are capable of functioning as whistleblowers. 43 per cent of respondents report that they are not satisfied with the level of efficiency of the functioning of civil activists, compared with 65 per cent recorded among the investors group. It is concluded that corporate governance policy makers need clear policies to promote the activities of civil organizations, including free access to information and protection of their legal rights, especially whistleblower protection. The Kruskal-Wallis test results also found that there are no significant differences between the opinions of

the different groups, suggesting that all group members agree these institutions are not as efficient as they are expected to be.

6.4.8 Alternative Approaches to Promote Good Corporate Governance Practices

There are three possible regulatory approaches to promoting good corporate governance, namely: prescriptive; non-prescriptive; and, mixed or balanced approaches. The prescriptive approach requires companies to adopt specific corporate governance practices prescribed by regulations. The non-prescriptive approach allows companies to determine their own corporate governance practices, subject to voluntary disclosures of corporate governance practices that they are adopted. The mixed or balanced approach consists of the characteristics of both prescriptive and non-prescriptive approaches, where only essential governance practices are prescribed, and detailed governance practices are normally published in accordance with voluntarily corporate governance codes. Presently the mixed approach is adopted in Sri Lanka. In order to understand the respondents' views regarding the most suitable approach to promote good corporate governance practices in Sri Lanka, respondents are asked to choose among these three approaches. The summarized results of respondents' views are given in Table 6.12.

Table 6.13 Approaches to Promote Corporate Governance Practices

Approaches		NED	IAP	ACC	GPM	GATO	ACD	INV	ALL
Prescriptive approach		23%	18%	31%	25%	21%	21%	21%	23%
	No.	9	6	14	11	13	6	5	64
Mixed approach		78%	82%	69%	75%	74%	72%	79%	75%
	No.	31	27	31	33	46	21	19	208
Non- prescriptive approach		0%	0%	0%	0%	5%	7%	0%	2%
	No.	0	0	0	0	3	2	0	5
Total Respondents		**40**	**33**	**45**	**44**	**62**	**29**	**24**	**277**

Notes: NED – Non-executive Directors; IAP – Independent Audit Professionals; ACC - Accountants; GPM – Government Policy Makers; GATO - Government Audit and Tax Officers; ACD - Academics; INV - Investors

75 per cent of respondents prefer the mixed approach. Only two per cent of respondents selected the prescriptive approach as their preferred approach. These results reflect the true nature of corporate governance. There is no universally acceptable model which fits all circumstances to achieve good corporate governance practices. Although widely accepted principles are set, the implementation of these principles differ according to various circumstances and conditions such as cultural values of the society, the legal framework of the jurisdiction, industry, and institutional cultures and value systems of organizations. Thus, a majority of respondents prefer

organizations to enjoy some regulatory flexibility in implementing good corporate governance practices. However, 23 per cent of respondents prefer the prescriptive approach. This opinion may have been motivated by the lack of commitment of Sri Lankan companies in implementing corporate governance best practices. As shown in the Section 5.4, the compliance to corporate governance practices diverges considerably among Sri Lankan companies. Thus, a number of respondents believe the prescriptive approach better severs the purpose of promoting good corporate governance practices in Sri Lankan companies.

6.5 Issues of Corporate Governance Identified by Stakeholders

In addition to opinion survey questions, the questionnaire includes two open-ended questions in which respondents could make comments. In the first question, the respondents are given the opportunity to express their opinion on perceived corporate governance problems or issues faced by Sri Lankan companies. Altogether 113 respondents commented. When analysing these comments, several themes emerge. Seven themes are identified as most significant to the respondents. These themes are: lack of education and awareness of corporate governance; inadequate regulations and enforcement; lack of integrity and independence of directors; insufficient ethical standards; lack of transparency; ownership concentration; and, corruption, insider trading and political interventions. Detailed findings and some of the comments of the respondents are illustrated below.

The lack of awareness and proper education of corporate governance is highlighted as a significant issue by most respondents. Approximately 30 per cent of respondents (33 of 113) recognize lack of awareness as a major issue. Specifically identified were: a lack of qualified staff; inadequate awareness about corporate governance among various stakeholders; inadequate understanding about corporate governance practices and their benefits; and, a lack of interest and inadequate knowledge with regard to benefits that can be acquired through applying corporate governance. The following are notable comments of respondents on this theme.

“The pressure from investors to improve corporate governance is minimal due to their lack of understanding.”

“Misunderstandings and misconceptions about governance; e.g. Governance impedes growth.”

“We never attempt to address the vacuum in educational system when grooming the managers.”

“Top management is not up to date with the latest pronouncements on best corporate governance codes and regulations.”

“Lack of pressure from the media and the public to improve corporate governance due to their lack of understanding of its importance”

Inadequate regulations and enforcement are highlighted as a significant issue by 28 respondents. Regulatory failures, an inefficient regulatory framework, a lack of guidance given to companies by regulatory authorities, a lack of monitoring mechanisms in governance rules, and an absence of an authoritative institution with wider regulatory powers are some of the problems highlighted by respondents in relation to regulations and enforcement. The following are some of comments made on regulatory issues.

“Bureaucrats in the regulatory institutions do not understand the concepts fully and therefore they focus on trivial matters rather than on fundamentals”

“It is important to get the balance between performance and governance/regulations right. Must avoid 6-star governance in a 3-star economy”

“Regulations must be strict and at the same time flexible, they should address key loopholes in the governance mechanism”

“Violation of established corporate governance rules are occurring as a result of lack of commitment to prosecute under existing law”

“Legal bodies who carry out inquiries and investigations are acting like puppets”

“Companies do not consider corporate governance seriously since it is not a legal requirement”

About 23 per cent of respondents (26 of 113) made observations on the lack of integrity and independence of directors as a significant problem in Sri Lankan companies. The shortage of persons of integrity and character to fill pools of independent directors; problems of securing independence of independent directors and not appointing independent or non-executive directors as the chairman of audit committees are some of common problems highlighted by the respondents. Some of the striking comments made by respondents on directors' independence and integrity are given below.

"Independent directors are often friends and relatives of the principle shareholders and therefore do not act independently"

"The main principle that drives good governance is integrity of the management and the employees."

"Independent directors are in fact not independent as they are appointed by dependent directors in most cases"

Insufficient ethical behaviour among directors and managers has been identified by 22 respondents as another problem of Sri Lankan corporate governance. Poor ethical standards of top management; a lack of responsibility towards the stakeholders and the society; a lack of trustworthiness of accounting and auditing practices; and, undue influence to promote unethical business from politicians are among the issues highlighted. Some comments that are worth mentioning are;

"Roles of executive and non-executive directors do not show proper professional behaviour"

"Managers simply tend to cow tow to the whims of the bosses to safe guard the job"

"Lack of trustworthiness of accounting and auditing practices"

Lack of transparency earned 16 comments from the respondents. Identified issues are: key decisions and the rationales of such decisions are not transparent; a lack of transparency regarding directors' remuneration; and, a lack of transparency in

applying governance codes are some of the repeated comments made by the respondents. Examples of such comments are given below.

"Most of the Sri Lankan companies are practicing corporate governance rules since they are compulsory, but the transparency and the effectiveness of these practices are doubtful as there is no transparency."

"In some companies the major shareholders are family members therefore lack of transparency becomes a common problem"

Concentration of ownership is also identified by twelve respondents as a significant issue faced by Sri Lankan companies. One of the salient facts regarding ownership concentration is that the ultimate ownership of most of the companies lies with a few individuals, more often family members and close friends, preventing effective corporate practices. Respondents' views are reflected further by the following comments.

"Most of the company directors are shareholders of the company, more over family members, who do not want to apply corporate governance"

"Most of the public companies are family businesses; hence owners are not willing to delegate powers to the directors and top management of the company"

"Presence of major shareholders with controlling of about 35% - 60% of issued share capital is noticed in most of the companies. Hence, the interest in governance is merely a compliance issue"

"The ownership structure of most of the companies has not been widely spread"

Undue political influence and corruption are widely accepted as problems in emerging economies. Political influence, corruption and insider trading are interchangeably highlighted by over 30 respondents in the survey. Government intervention in business transactions; political interventions; endemic corruption between the state and private sector dealings; a vicious circle of corruption due to a lack of strong legislation; and, insider trading and unethical behaviour of directors are

identified repeatedly in some of the remarks given by respondents. Respondents' views on these issues are further revealed by the following comments.

"Too many interventions by both the shareholders and the government, hence the management and the directors in the board are biased in decision making"

"The president acting as the minister of finance"

"The old boy network that exists in the private sector which leads to overlook the venalities of directors and top management if they are in their good books"

"CG in Sri Lanka is pathetic. All the big players cover-up themselves using their high hand connections when an issue comes-up"

"It seems that many directors are involved in insider trading and unethical cross holding of shares in order to achieve individual targets as well as to support the political wing which they belong to"

The summarized results given in Table 6.9 show that most of the given corporate governance issues (refer question 10 in the questionnaire) are considered as the major problems by the respondents. In addition to these issues, the problems discussed in the preceding section have collectively been recognized by respondents based on their experience and expertise.

6.6 Recommendations Made by Stakeholders

In the second open ended question, the respondents were given the opportunity to make recommendations to improve corporate governance in Sri Lanka. Altogether 94 respondents make their recommendations. These recommendations are categorized under five basic themes: more regulations and regulatory monitoring; sufficient education; more emphasis on judiciary enforcement: increased ethical standards; and, prevention of political intervention. Detailed findings and some of the comments of the respondents are illustrated below.

Placing more emphasis on rules and regulations is found to be the most cited recommendation which is made by 30 respondents. It's a notable fact that about half of

the recommendations made by members in the IAP and GPM groups focus on increasing regulations and regulatory monitoring. However, a few recommendations go against strict regulation, arguing the need for more relaxed voluntary application of governance practices. Some of the comments which highlight their suggestions are worth mentioning.

"Obtaining corporate governance ratings and disclosing them in the annual reports should be made compulsory"

"Regulatory authorities must guide and review the corporate governance practices of companies on a regular basis"

"ICSAL should introduce proper monitoring system to identify the practicing members' bad practices on corporate governance with coordination of other regulatory bodies and general public"

"Impose rules and regulations to get quick actions against violations"

"It is important to establish a separate regulatory institution having combine characteristics of executive and judiciary similar to the Department of Labour and Labour Tribunal"

"Regulations need to be strict and monitoring of adherence to corporate governance regulations need to be done more rigorously"

"The regulators should be given more power and autonomy to act on their own without intervention from other parties"

"Close monitoring of SEC, CSE, Central Bank and the Judiciary"

"Principle-based corporate governance is likely to be more effective than rule-based approach. Rules tend to be broken or circumvented, whereas corporate governance implemented out of conviction would yield better results."

"Need to go beyond the declaration in Annual Reports. Most Companies pay lip-service to the corporate governance guidelines."

Educating board members, management, employees and stakeholders about principles and policies, best practices, regulatory requirements, and performance implications of corporate governance is also a strong suggestion made by the respondents, especially academics. Over 25% of respondents commented on this issue. They even go to the extent of suggesting that education on corporate governance needs to be started in secondary education, followed by higher education, essentially before holding managerial positions. Introducing corporate governance as a subject in accounting and business degrees and accounting professional qualifications; compiling simple and understandable corporate governance guidelines which can be understood even by a layman and conducting awareness programs for stakeholders by professional institutions are some of the frequent recommendations made by the respondents. The importance of education and awareness of corporate governance is well reflected from the following comments.

"Education, Education, Education at middle and operational management level"

"Corporate governance is a culture: state of mind. It all starts from the school level and home."

"All professionals should be educated in this regard before they become professionals and this should be tested in their professional exams"

"Business community has to be educated about corporate governance practices and their benefits"

"Basic concepts of the corporate governance and ethics should be included in the education syllabus of the school level"

"Directors of the companies, Head of finances of the companies and Audit firm partners should be improved of their knowledge about corporate governance through seminars and any other communication tool."

"We need to seriously pay attention in the development of curriculum for secondary and higher education stages to ensure that adequate weight is given to instil the values of good governance among the student population."

Another significant recommendation of respondents is the strengthening of the judiciary and judicial enforcement system. They suggest that the judicial system on governance has to be tightened and reinforced with more powers. Severe punishment for those who violate governance rules and regulations are among the common recommendations. Some relevant comments are listed below:

"Company legislation has to be periodically revised in line with the global changes"

"Activate company law review committees"

"The judiciary system on governance has to be tightened"

"Regulators should act fearlessly and objectively to punish violators irrespective of the person concerned"

"Very tight rules to be brought giving more powers to the judiciary system in Sri Lanka"

"Effective judiciary system, especially for related business activities"

Respondents emphasize improving ethical standards of companies. Over 15 per cent of responses focus on this issue. Most of them are of the view that ethical standards have to be cultivated from a very young age. Some responses are as follows:

"Basic concepts of corporate governance and ethics should be included in the curriculum at school level"

"Values, integrity and ethical behaviour together with cultural values should be improved as a long term solution"

"Importance of ethics and integrity imbibed from very young age"

"Ethical standards commencing from the school level and all social institutions should drive this concepts"

Prevention of political intervention also is another significant recommendation made by the respondents. The respondents are of the view that the prevention of corruptive links between large businesses and politicians may result in a more

favourable business environment for small and medium scale businesses and secure equitable distribution of income. The respondents' attitudes are summarized as follows;

"No political influences should be directed towards statutory authority"

"A clear common line of sight without personal prejudices"

"Sri Lanka should first have an honest political leadership who obey the judiciary decisions. Political governance before corporate governance"

The summarized results given in Table 6.11 show that majority of respondents agree that Sri Lankan corporate governance can be improved by adhering to good governance practices. In addition to specific governance practices, they collectively agree that these aspects also need to be addressed in order to improve the overall corporate governance environment in Sri Lanka.

6.7 Summary

This chapter examines perceptions of various stakeholder groups on the present status, issues, strategies and practices of the corporate governance system of Sri Lanka. This is achieved by examining the perceptions of seven stakeholder groups through a questionnaire survey of 277 stakeholders. In this process, stakeholder perceptions on eight aspects of the corporate governance system in Sri Lanka are examined. The Kruskal-Wallis test is carried out to examine whether there are significant differences between opinions of stakeholder groups. Furthermore, the stakeholders' perceptions of problems of corporate governance and their recommendations to cope with these problems are analysed in order to identify their real concerns about corporate governance.

The findings of this study reveal that various stakeholders consider: governance codes; the financial reporting framework; the regulatory framework; and, codes of conduct and ethics, as the important components of the corporate governance system of the country. However, their emphasis on the judiciary system, corporate ownership structure, and culture and value systems of the society as important components of the corporate governance system is relatively low. The examination of performance implications of corporate governance reveals that the majority of respondents consider better corporate governance improves financial, market and corporate social

performance, and ability to access new capital. However, the impact of corporate governance on reducing share price volatility, political intervention and cost of capital has earned relatively low levels of agreement. The stakeholders' opinions on corporate governance reveal that a majority of respondents are not happy with the present status of various aspects of Sri Lanka's corporate governance system. The majority believe that the governance system is not comparable to that of a developed country and the specific aspects such as regulations, implementation and monitoring are also not adequate.

The examination of the perceptions on various issues of corporate governance reveals that all the given issues of: a lack of integrity; a lack of independence; inadequate transparency; insider trading; inadequate protection of minority shareholders; and, conflicts of interest of directors are considered major issues by the respondents. It is also found that the majority of respondents agree to several corporate governance strategies such as the development of internal and external governance mechanisms and improvement of accounting and auditing standards are suitable to improve the efficiency of corporate governance practices. However, changing ownership concentrations is not accepted as a successful strategy. On examination of the importance of certain governance practices, the majority of respondents agree that: giving greater powers to audit committees; full disclosure of RPT's; separation of the CEO and chairman positions; independence of NEDs; and, adoption of codes of conduct and ethics as importance practices. The investigation of suitable approaches to promote good governance practices in Sri Lanka reveals that an overwhelming majority opt for the balanced approach.

When the respondents are given the opportunity to comment on perceptions of major corporate governance problems in Sri Lanka, they recognize a number of issues based on their experience and expertise. After classifying these issues under several themes, it is revealed that: a lack of education and awareness of corporate governance; inadequate regulations and enforcement; a lack of integrity and independence of directors; insufficient ethical standards; a lack of transparency; ownership concentration; and, political interventions, insider trading and corruption are recognized by most as major problems in Sri Lanka. Furthermore, their recommendations to improve corporate governance practices consist of five main aspects: namely strict

regulations and regulatory monitoring; sufficient education; more emphasis on judiciary enforcement; increased ethical standards; and, prevention of political intervention.

The findings of this corporate governance survey (refer Section 5.3.3) reveal that ownership of Sri Lankan companies is highly concentrated and family ownership concentration impacts negatively on corporate governance compliance. These findings are consistent with stakeholders' perceptions as a majority of respondents recognize ownership concentration as a major corporate governance problem. However, the impact of ownership concentration on company performance is yet to be explored in Sri Lanka. Thus, this impact is examined in the next chapter.

Chapter 7 : The Impact of Ownership Concentration on Firm Performance of Sri Lankan Companies

7.1 Introduction

The survey analysis shows (refer Section 5.3.3) the ownership of Sri Lankan listed companies is highly concentrated, with a presence of controlling shareholders. It further reveals that in most cases, ownership is concentrated either with family owners or foreign owners. These survey results are consistent with previous research conducted in Sri Lanka regarding share ownership of public listed companies. For example, the studies of Samarakoon (1999) and Senaratne and Gunaratne (2007) reveal that the ownership structure of Sri Lankan listed firms is characterized by highly concentrated ownership with the presence of a controlling shareholder, usually another corporate entity, and with family owners holding ultimate ownership. The survey results of this study further reveal that family ownership has considerable negative impact, whereas foreign ownership has significant positive impact on the corporate governance of firms (refer Section 5.5.3).

Relationship-based businesses, especially within family owned group affiliations, are a common cultural tendency in Sri Lanka. Thus, the lack of applicability of the Anglo-Saxon model may contribute to low levels of governance compliance experienced by family owned companies. Irrespective of low compliance to corporate governance practices by family based companies, it can be assumed that ownership concentration leads to better performance in Sri Lankan companies as a result of controlling shareholders' direct participation in business affairs, which reduces monitoring costs and encourages relationship based business practices. This study examines the impact of ownership concentration and structure on firm performance in Sri Lanka.Since no prior research on this aspect of Sri Lankan companies has been reported in the literature to date, the findings of this study provide valuable insights to Sri Lankan policy makers for improving corporate governance of the country.

This chapter presents the empirical analysis and findings of objective seven of the study. The analysis is presented in the following sequence. First, a brief discussion on the background of the study is provided with reference to: performance implications of ownership concentration; Sri Lankan corporate governance; and, its affiliated social

conditions. Secondly, a brief review of regulatory requirements for shareholding in Sri Lankan listed companies is provided. In the third section, the sample companies' profile and the nature of ownership concentration of sample companies are examined. In the next section, the analysis and empirical findings are discussed with reference to findings of prior research. The summary is then provided in the final section.

7. 2 Relationship of Ownership and Performance

Much of the literature on corporate ownership structure show a high level of ownership concentration in many countries — especially outside the Anglo-Saxon countries (Shleifer and Vishny, 1997; La Porta et al., 1999; Kapopoulos and Lazaretou, 2007). Many studies examine the impact of ownership concentration on performance, concluding that higher ownership concentration may improve performance by decreasing monitoring costs. Alternatively, performance can decline if large shareholders use their control rights to achieve private benefits (Demsetz and Lehn, 1985; Shleifer and Vishny, 1986; Morck et al., 1988; Leech and Leahy, 1991; Thomsen et al., 2006; Zeitun and Tian, 2007). As most of these studies are conducted in developed economies, their results cannot be generalized without paying attention to contextual idiosyncrasies.

The contextual settings of developed countries differ vastly from those of emerging markets; therefore, the findings and theories based on the evidence collected from developed countries may have limited applicability to emerging markets. As Zeitun and Tian (2007) point out, the social, economic and cultural factors of a country affect corporate ownership structure, which in turn impacts on firm performance. Very little is known about the performance implications of ownership structures in emerging markets, and there is a dearth of studies in this area. This issue, combined with the divergent results produced by similar previous studies conducted in developed economies (Morck et al., 1988, La Porta et al., 2002, Gompers et al., 2003, Drobetz et al., 2004), creates a vacuum in the academic literature on corporate governance practices in emerging markets.

As in many other emerging markets in Asia, the ownership of Sri Lankan companies is highly concentrated, with a presence of controlling shareholders in most

enterprises (refer Section 5.3.3). Sri Lankan corporate entities have strong historical ties with the systems inherited from British colonial rule. For example, Sri Lankan accounting and auditing systems are products of British inheritance and more recently, international standards and practices (Asian Development Bank, 2002). Sri Lanka adopted liberalized economic policies from 1977, and is heavily dependent upon foreign aid and foreign direct investment for its economic development. These adopted policies permit international funding agencies such as the World Bank, the International Monetary Fund (IMF) and the Asian Development Bank to directly influence corporate governance practices and policies of the country. Furthermore, these historical ties and economic policies influence foreign ownership concentration in Sri Lankan companies. However, traditionally, relationship-based businesses, especially within family owned group affiliations, are a common cultural tendency in Sri Lanka. This kind of inconsistency creates a challenging environment for Sri Lankan companies to achieve strong financial performance while at the same time maintaining a high level of compliance with prescribed corporate governance practices.

Corporate control in Sri Lanka often lies in the hands of a few individuals, families or corporate groups who hold the majority of ownership. Existing governance structures of Sri Lankan companies, characterized by controlling shareholders, show similarities to an 'insider' corporate governance model, as ownership concentration tends to produce better financial performance for Sri Lankan companies. Furthermore, ownership concentration by individuals rather than institutions tends to produce better performance (Zeitun and Tian, 2007). However, whether this type of ownership concentration affects firm performance has not been examined in any prior research on Sri Lanka. In order to examine the impact of ownership concentration and structure on firm performance, this chapter addresses the following questions:

(1) Is there any impact of *ownership concentration* on firm performance of Sri Lankan-listed companies?

(2) Is there any impact of *ownership structure* on firm performance of Sri Lankan-listed companies?

Regression analysis is carried out based on the sample data and the empirical analysis and the results are provided in Section 7.6 of this chapter.

7.3 Regulations Governing Shareholdings of Sri Lankan Listed Companies

Listed companies in Sri Lanka are governed by various regulations such as the *Companies Act* No. 07 of 2007, the CSE bylaws, and SEC bylaws. As per the provisions of the *Companies Act*, a limited liability company can be started with two shareholders. However, the CSE requires companies to satisfy a specified public float at the time of initial listing, as well as thereafter. In order to be quoted on the Main Board, a company should have stated capital representing shares of a value of not less than 100 million rupees and have a minimum public holding of 25 per cent of the total number of shares, which shall be in the hands of a minimum number of 1000 public shareholders holding not less than 100 shares each. However, there is provision in the listing rule to accept lower than 25 per cent of public holding, if the CSE is satisfied that such a lower percentage is sufficient for a liquid market. A quotation in the Second Board requires a company to have a stated capital representing shares of a value of not less than 35 million rupees and have a public holding of 10 per cent (CSE 2009).

The public holding is the percentage of shares that must be held by the public, excluding share holdings by parent, subsidiary or associate companies, and holdings by directors, members of their families and/or their nominees. The listed company must disclose the names and the number of shares held by the 20 largest holders along with the percentage of such shares held. It also requires disclosing the public share holding percentage. Furthermore, companies are expected to disclose the categories of shareholdings such as individual and institutional shareholdings, and resident and non-resident shareholdings. It is expected that these disclosures act as a self regulating control mechanism in order to maintain minimum public share holding requirements. It is the duty of the board of directors to ensure that all rules are met on a continuing basis. The minimum public holding maintained by some companies falls short of the required float, as these requirements are not properly monitored on a continuous basis.

The *Company Takeover and Merger Code* of 1995, as amended in 2003, imposes restrictions on acquiring large blocks of shares of a company when the target company is a public limited company. The purpose of this Code is to ensure fairness for all shareholders, especially for non-controlling shareholders in relation to a takeover. According to this Code, SEC approval is required for any takeover offer. The SEC may

grant its approval for an offer which results in the ‘offerer’ holding shares carrying less than 30 per cent of the voting rights of the ‘offeree’ company. However, if an ‘offerer’ intends to acquire shares carrying 30 per cent or more of the voting rights of the ‘offeree’ company, or holds not less than 30 per cent and not exceeding 50 per cent of the voting rights of the ‘offeree’ company, and acquires additional shares carrying more than two per cent of the voting rights, they are obligated to make a mandatory offer to all the remaining shareholders in order to obtain SEC approval for such an offer. Although the mandatory offer is intended to ensure the rights of non-controlling shareholders in a takeover bid, it does not restrict ownership concentration since any individual or person can acquire a majority shareholding of a public limited company, causing a highly concentrated ownership structure for listed companies.

The bank, finance and insurance sector in Sri Lanka is governed by specific acts and regulations where restrictions are imposed on share transfers and share ownership. For example, according to the direction given by the monetary board under section 46(1) (d) of the *Banking Act* No. 30 of 1988, no person or company may hold more than 15 per cent of issued share capital carrying voting rights in a licensed commercial bank incorporated in Sri Lanka. As a result, relatively dispersed ownership structures are observed in the banking sector, compared with non-banking counterparts.

The listing rules attempt to minimise share ownership concentration by stipulating a minimum number of share holdings by the public. However, the regulators expect directors to implement these requirements without having adequate enforcement of the code. The *Mergers Code of 1985*, although codifying non-controlling shareholders’ rights, does not restrict ownership concentration through mergers and acquisitions. A lack of provisions as well as implementation weaknesses allows Sri Lankan listed companies to have controlling owners with large percentages of share ownership, leaving only a small percentage for the public. However, the *Banking Act* restricts the share ownership concentration and therefore the finance sector’s share ownership behaviour cannot be compared with other sectors in the market.

7.4 Issues in Estimating the Ownership and Performance Measures

Many empirical studies which examine the relationship between firm ownership and performance use both accounting and market measures concurrently, or market performance measures alone, such as Tobin's Q (TQ) (Demsetz and Lehn, 1985; Morck et al., 1988; Agrawal and Knoeber, 1996; Demsetz and Villalonga, 2001; Thomsen et al., 2006; Kapopoulos and Lazaretou, 2007; Zeitun and Tian 2007). As discussed in Section 4.7.3, this study uses both accounting and market performance measures. While ROA is used to measure how well a firm is using its resources, TQ measures a firm's performance in the market. In addition, ROE is also used on the grounds that owners normally have the strongest needs and incentives to be informed about the residual income of the firm. In theory, the TQ ratio identifies the combination of the marginal efficiency of capital and the financial cost of capital. Thus, the TQ ratio is positively related to investors' perceptions of managerial quality. This suggests investors are willing to pay a premium over the value of the firm's assets in anticipation of good future prospects under the present management (Demsetz and Lehn, 1985). The TQ ratio can therefore be employed as a proxy for the market valuation of the firm's assets, whereas accounting profit is an estimate of what management has accomplished. However caution is needed in estimating and interpreting such measures, as they are subject to measurement problems. TQ is normally affected by investors' psychology concerning their future expectations of the market, whereas accounting profit is not affected by such expectations. As small markets are more vulnerable to market manipulations and insider dealings, in Sri Lanka accounting performance measures could be better indicators of firm performance, rather than market measures.

It is true that accounting performance variables are subject to various limitations which typically result from the fundamental limitations of financial statements. Though the financial statements are prepared based on generally accepted accounting standards, the accounting process is dominated by subjective interpretations of standards and the application of firm-specific accounting rules and policies. This makes it difficult to compare firm performance measured in accounting terms in a realistic manner. Despite this inherent limitation, the applicable legal requirements and the financial statement preparation process of Sri Lankan listed firms are on par with the international standards in many respects. The Sri Lankan firms are required to prepare financial statements

based on *Sri Lanka Accounting Standards* which are fully compliant with the *International Financial Reporting Standards (IFRS)*. The financial statements of Sri Lankan companies are required to be audited by a qualified auditor as per the *Companies Act* No.07 of 2007. Furthermore, as stated Section 7.3, they are required to comply with the listing rules of the CSE and are subject to constant monitoring by the SEC and the Sri Lanka Accounting and Auditing Standards Monitoring Board. The published financial statements can therefore serve as the prime data source for obtaining information in measuring accounting performance of companies (De Zoysa and Rudkin, 2010).

Market performance measures, especially TQ, also suffer from accounting measurement problems. Prior studies which examine the performance implications of ownership structure argue that accounting and market performance measures differ in at least two important aspects (Demsetz 1983; Demsetz and Lehn, 1985; Morck et al., 1988; Agrawal and Knoeber, 1996; and Demsetz and Villalonga, 2001; Kapopoulos and Lazaretou, 2007). The first relates to the time horizon. Accounting profit is based on the historical performance of the firm, and is therefore a backward-looking measure; while the TQ ratio reflects the investors' expectations, and is therefore a forward-looking measure. The second difference arises due to measurement problems: accounting profit is largely distorted by accounting principles, but TQ is based on market values and thus it is claimed that it is less vulnerable to distortion. However, market values are affected by investors' expectations about future events, which are subject to manipulations, signalling, group behaviour, and mistakes (Kapopoulos and Lazaretou, 2007). This makes TQ less reliable, especially in a small market where more market manipulation is possible. Furthermore, TQ also suffers from accounting measurement problems, due to the use of proxy book values in place of replacement values of tangible assets. Book values generally have problems caused by inflation and arbitrary depreciation choices. TQ does not reveal the investment made in intangibles; and neither does it reflect the value placed by investors in intangibles (Kapopoulos and Lazaretou, 2007). Due to these reasons, the validity of TQ as a performance measure is debatable, especially in an emerging market where market anomalies and inefficiencies play a dominant role in deciding the market price for securities.

Many prior studies which examine the impact of ownership structure on firm performance employ the fraction of shares owned to identify influential shareholders, on the assumption that those shareholders owning a greater fraction of shares in a firm have greater influence on strategic and operating decisions compared with those shareholders owning smaller fractions of shares (Demsetz and Lehn, 1985; Morck et al., 1988; Demsetz and Villalonga, 2001; Kapopoulos and Lazaretou, 2007; and Zeitun and Tian 2007). Consistent with this argument, the fraction of shares owned is applied in all measures of ownership concentration and structure used in this study. The fraction of share ownership of the three (SH_3), five (SH_5) and ten (SH_{10}) largest shareholders is given priority in estimating concentration ratios. The Herfindahl Index (HERF), which gives greater weighting to shareholders with larger shareholdings, is used to measure the fraction of shares owned by the top five shareholders.

Agency theory argues that investors are protected from abuse by management if ownership is concentrated with a few large shareholders, as they can effectively monitor the functions of management. The fraction of shares owned by the largest shareholders is not a reliable measure of the protection of investors if management holds a larger fraction of shares, putting them into the significant shareholders' category. Thus, some studies use managerial ownership as an essential variable of ownership structure (Demsetz and Villalonga, 2001; Kapopoulos and Lazaretou 2007,). Direct managerial ownership in Sri Lankan companies is relatively small, because ownership is usually dominated by another corporate entity. The data analysis shows that of the total issued share capital of the sample companies, on average 70 per cent of shares are owned by other corporate entities (refer table 7.3). These entities are usually other limited liability companies and they more often have family ownership as the ultimate owners. Direct managerial ownership therefore does not play an influential role in the Sri Lankan context. However, controlling owners have more power to participate in the operational activities of a firm, especially in the Sri Lankan market, where controlling shareholders' influence over management is high. For example, the survey results show that over 70 of the companies have controlling shareholders' influence in major decisions (refer Section 5.3.3 and Table 5.6). On the basis of these arguments, this study investigates the impact of ownership structure on firm performance using the fraction of shares owned by individuals (F-Ind) and fractions of shares owned by a corporate entity (F-Com), instead of using managerial share ownership.

Another issue that needs to be addressed in this study is whether the ownership structure of Sri Lankan companies is endogenous to performance. If the ownership structure is endogenous as argued by Demsetz and Lehn (1985), ownership is more likely to be affected by firm performance. Managerial ownership has been found to be affected by performance due to factors such as performance based compensation and insider information. Management compensation in the form of stock options is found to be one of the main reasons for a reverse causation where firm performance affects ownership structure (Himmelberg et al., 1999). Performance based compensation and stock options for executives are extremely low in Sri Lankan companies. For example, the survey shows that over 85 per cent of companies do not use stock options or performance based compensation for their directors (refer Section 5.4.3). Thus, the impact of performance on ownership structure, especially managerial ownership is likely to be low in Sri Lankan companies.

The ownership is likely to be exogenous to performance in a corporate governance system where ownership structure is much more stable, (Gugler and Weigand, 2003). The ownership structure of Sri Lankan listed firms is very steady and characterized by: concentrated ownership with the presence of controlling shareholders; controlling ownership usually held by another corporate entity; and, ultimate ownership is held by family owners (refer Section 5.3.3 and Table 5.6). These factors guide Sri Lankan firms to have stable ownership structures, and therefore ownership is more likely to be exogenous to performance. If the ownership structure is endogenous, it must be taken into account when determining the relationship between ownership and performance. Failing to do so may yield biased regression estimates. As the ownership structure of Sri Lankan companies is more likely to be exogenous to performance, this study does not examine the endogeneity of ownership structure. Further, it assumes that regression estimates do not yield bias results due to the endogeneity issue. Consequently, greater emphasis is given to ownership concentration amongst the first five largest shareholders and the fraction of shares owned by individuals vs. corporate entities, assuming these ownerships are exogenous to performance.

7.5 The Sample profile

The sample of the study consists of 157 companies listed on the CSE over the period 2001–2009. On average, 230 companies are listed on CSE during this period and thus the sample represents approximately 68 per cent of the listed companies in Sri Lanka. However, missing data across the sample period reduces the sample. The final sample consists of 846 firm-years. Table 7.1 presents the sample profile of companies across years and industry sectors. These companies belong to different industrial sectors, of which the manufacturing sector represents the largest number of companies (26 per cent) in the sample. As per Table 7.1, the number of companies in each industry sector ranges between 3 per cent and 26 per cent.

Table 7.1 Profile of the Sample

Year	Firm-Years	%	Industry	Total Firms	Sample	Sample %	Firm-Years	%
2009	148	17.5	Beverage and food	18	14	78	95	11.2
2008	154	18.2	Diversified	11	7	64	48	5.7
2007	149	17.6	Health	6	6	100	21	2.5
2006	114	13.5	Hotel	32	25	78	123	14.5
2005	54	6.4	Invest. & property	29	11	38	65	7.7
2004	26	3.1	Manufacturing	45	40	89	220	26.0
2003	30	3.5	Motors	6	6	100	42	5.0
2002	87	10.3	Plantations	18	22	122	108	12.8
2001	84	9.9	Service and trading	20	17	85	79	9.3
			Other	12	9	75	45	5.3
			Bank and Finance	33	-	-	-	-
Total	**846**	**100**	**Total**	**230**	**157**	**68**	**846**	**100**

The data set contains detailed information on performance, measured in terms of: accounting and market returns; ownership concentration (OC); ownership structure (OS); and, other financial information capable of measuring the size, age and leverage of the companies. Table 7.2 provides a profile of the sample companies, giving an indication of size, operational experience and profitability.

Table 7.2 shows a significant dispersion among sample companies in respect of size, as measured by: total assets; sales; age; and, return on assets. The total assets of the sample companies ranged from 6 million rupees to 96,188 million rupees, showing a substantial variation among companies. While the average total assets of companies

amounted to 3,948 million rupees, the total assets of a sizeable proportion of these companies (41 per cent) are less than 1,000 million rupees. A similar situation emerges when the size of companies is measured in terms of sales, which varies from 0.07 million rupees to 47,939 million rupees, also showing a substantial disparity between sample companies. The sample of companies consists of both young and old enterprises, with their age ranging from one to 164 years. The majority of companies in the sample (60 per cent) are under 30 years old, while only 23 per cent of companies are over 50 years old. As for the profitability level of companies, once again there is a wide disparity. While 676 firm-years in the sample reported positive returns, the remaining 170 firm-years reported negative returns on their assets from the sample period. The average profitability ratio of the sample companies is 5.5 per cent, while the majority of companies (65 per cent) earned less than 7.5 per cent of return on their assets.

Table 7.2 Profile of Sample Companies

Total Assets

Rs millions	Frequency	%
0–100	51	6
101–500	148	17.5
501–1,000	146	17.3
1,001–5,000	358	42.3
5,001–10,000	78	9.2
>10,000	65	7.7
Total	846	100
Descriptive statistics		**Rs. millions**
Mean		3,948
Standard deviation		9,482
Minimum		6
Maximum		96,188

Sales

Rs millions	Frequency	%
0–25	41	4.8
26–100	90	10.6
101–1,000	286	33.8
1,001–2,500	191	22.6
2,501–10,000	163	19.3
>10,000	75	8.9
Total	846	100
Descriptive statistics		**Rs. millions**
Mean		3,151
Standard deviation		6,172
Minimum		0.07
Maximum		47,939

Age

Years	Frequency	%
0–5	16	1.9
6–15	181	21.4
16–30	316	37.4
31–50	141	16.7
51–100	145	17.1
> 100	47	5.6
Total	846	100
Descriptive statistics		**Years**
Mean		38
Standard deviation		32
Minimum		1
Maximum		164

Return on Assets

Per cent	Frequency	%
< −10%	29	3.4
−10–0%	141	16.7
0–7.5%	383	45.3
7.5–15%	206	24.3
15–30%	76	9
> 30%	11	1.3
Total	846	100
Descriptive statistics		**Per cent**
Mean		5.49
Standard deviation		10.24
Minimum		−113.22
Maximum		87.83

7.6 Analysis, Results and Discussion

7.6.1 Summary Statistics

The ownership and performance variables are initially examined with exploratory data analysis and descriptive statistics and the results are shown in Table 7.3. The descriptive statistics shows that the first three OC ratios (SH_3, SH_5 and SH_{10}) indicate a high ownership concentration in the sample of Sri Lankan companies. Specifically, the mean values of each of the three OC ratios in the sample were above 70 per cent, with an overall mean value of 77 per cent. The data also indicates that a substantial variation across firms in ownership concentration exists. The average range of the three OC ratios is 66 per cent, with an average standard deviation (SD) of 14 per cent. The data in Table 2 reveals that the first ten-largest shareholders (approximately 80 per cent of the sample firms) held over 75 per cent of shares. This indicates that the majority of firms are not in compliance with the CSE listing rule requirement which stipulates that a minimum float of 25 per cent shares should be held by at least 1,000 shareholders. The forth OC ratio, the HERF index, further confirms the existence of a high concentration of ownership in Sri Lankan firms. As per the data in Table 7.3, the mean value of the HERF index amounted to 3,210. According to the merger guidelines issued by the US Department of Justice (2010), an HERF index in excess of 1,800 points is considered as a high concentration. This also indicates the presence of a controlling shareholder in most of the Sri Lankan firms surveyed.

Table 7.3 Descriptive Statistics of Variables; 2000–2008

Variables	Mean	Std. Dev.	Min.	Max.	Skewness	Kurtosis	Shapiro-Wilk	Prob.
ROA	5.49	10.24	−113.21	87.83	−0.817	28.430	.820	.000
ROE	8.09	24.45	−327.30	153.77	−3.380	48.640	.710	.000
Tobin Q	1.09	0.58	0.23	4.94	2.802	10.768	.741	.000
MBR	1.26	2.40	−9.33	55.01	14.757	309.140	.317	.000
SH_3	70.36	16.99	25.27	98.44	−0.452	−0.482	.960	.000
SH_5	77.51	13.94	30.27	98.87	−0.864	0.671	.939	.000
SH_{10}	84.06	10.90	41.48	99.76	−1.187	1.975	.917	.000
HERF	3,209	2,097	270	8,952	0.894	0.071	.920	.000
F-Ind	28.65	22.96	1.49	100.00	1.258	0.880	.863	.000
F-Com	71.34	22.96	0.00	98.50	−1.258	0.880	.863	.000
TD/TA	0.51	0.35	0.00	3.92	3.469	27.266	.770	.000
LN-TA	14.10	1.50	8.70	18.38	−0.218	0.487	.993	.000
LN-Age	3.31	0.79	0.00	5.10	−0.067	0.469	.977	.000
LN-TSal	13.57	1.93	4.24	17.68	−0.552	0.621	.981	.000

Sample (N) = 846.

While the results of this study suggest that Sri Lankan firms have high OC, the OS of firms as measured by fraction ratios, indicates greater corporate ownership compared to individual ownership. According to the data in Table 7.3, the average value of the fraction of shares owned by other corporate entities (F-Com) is 72 per cent, compared to 28 per cent owned by individuals (F-Ind).

In the correlation and regression analysis, SH_3 and the HERF index are used as an indicator of OC to investigate whether OC increases a firm's performance. The SH_3 ratio records the highest dispersion among the three OC ratios, with a range of 73 per cent and a standard deviation of 17 per cent. The HERF index is considered to be a good indicator of OC as it gives more weight to larger shareholders (or a controlling shareholder). The leverage, size and age are represented by the TD/TA ratio, log of total sales (LN- Tsal) and log of age (LN-Age) respectively.

7.6.2 Correlation Analysis

Table 7.4 presents the correlation matrix for the sample used. The results show a significant relationship between firm performance and OC variables. As expected, SH_3 is positively correlated to ROA, ROE and TQ and is significant at the 1% level for ROE and 5% level for ROA and TQ. The negative correlation between SH_3 and MBR hints at market anomalies prevailing in the Sri Lankan market. HERF is positively correlated with all performance variables and is significant at the 1% level for ROE and TQ. The correlation of structure ratios with performance variables show mixed results. F-Ind ratio is positive for ROA but it is negative for ROE and TQ. As expected, F-Com ratio is positively correlated to ROA but negatively correlated to ROE and TQ. The claim that higher individual ownership leads to higher firm performance whereas higher corporate ownership leads to poorer firm performance is not shown by the results.

The results of the correlation analysis further indicate the extent of correlation between the explanatory variables used in this study. The size of the firm is negatively correlated with the OC ratios, implying that larger firms tend to have more dispersed ownership. A similar relationship is observed between the age of the firms and OC ratios. The older firms tend to have less concentration, as they are normally subjected to expansion through public share issues. As expected, the two OS ratios, SH_3 and HERF, are highly correlated with each other. However, because they are used in the regression

model alternately, the high correlation between these two variables has no impact on the model. The result also shows that the F-Com ratio is positively correlated with the OC ratios. This implies that most of the Sri Lankan firms in the sample had parent companies as their principle shareholder, with larger share ownership. In addition, the negative relationship between F-Ind ratio and OC ratios shows that the individually owned companies were less concentrated.

Table 7.4 Correlation Matrix of Variables, 2000–2008

	ROA	ROE	TQ	MBR	SH3	HERF	F-Ind.	F-Com.	TD/TA	LN-Age
ROE	.523**	1								
	.000									
TQ	.009	.005	1							
	.799	.881								
MBR	-.003	-.459**	.410**	1						
	.939	.000	.000							
SH_3	.077*	.102**	.076*	-.005	1					
	.025	.003	.026	.876						
HERF	.055	.096**	.119**	.036	.825**	1				
	.108	.005	.001	.296	.000					
F-Ind	.001	-.075*	-.097**	.037	-.570**	-.556**	1			
	.980	.030	.005	.277	.000	.000				
F-Com	-.001	.075*	.097**	-.037	.570**	.556**	-1.0**	1		
	.980	.030	.005	.277	.000	.000	.000			
TD/TA	-.163**	.015	.321**	.038	-.034	-.040	.013	-.013	1	
	.000	.654	.000	.274	.325	.240	.702	.702		
LN-Age	.061	.042	-.022	.021	-.068*	-.023	.111**	-.111**	.046	1
	.078	.223	.524	.551	.049	.496	.001	.001	.185	
LN-TSal	.271**	.227**	-.067	-.022	-.042	-.067	-.020	.020	.262**	.109**
	.000	.000	.053	.523	.220	.052	.562	.562	.000	.002

Note: ** significant at 1% level, * significant at 5% level.

7.6.3 Regression Analysis

The Berle-Means (1932) thesis implies that diffuse ownership adversely affects firm performance. This assertion is tested by assessing the impact of OC on performance using pooled regression models. As illustrates in Table 7.4, the correlation coefficients of some explanatory variables are more than 50 per cent. This suggests the existence of multicollinearity among the variables in the regression models. Thus, a diagnostic test which show variance inflation factors (VIF) (collinearity statistics) is carried out with each regression model. The VIF quantifies the severity of multicollinearity of explanatory variables in the regression models. The summary scores of the VIF with correlation coefficients of explanatory variables are given in Table 7.5. The results indicate fewer than 2 scores for all variables in each regression model. In

general, VIF scores under 10 (or scores under 2.5 even in a weaker model) can be considered as a good indicator for non-multicollinearity (Gujarati, 2003).

Table 7.5 Correlation Matrix of Explanatory Variables, 2000–2008

	SH_3	HERF	F-Ind	F-Com	TD-TA	LN-Age	LN-TSal	VIF
SH_3	1							1.488
HERF	.825**	1						1.465
F-Ind	−.570**	−.556**	1					1.499
F-Com	.570**	.556**	−1.000**	1				1.499
TD-TA	−.034	−.040	.013	−.013	1			1.075
LN-Age	−.068*	−.023	.111**	−.111**	.046	1		1.026
LN-TSal	−.042	−.067	−.020	.020	.262**	.109**	1	1.090

Notes: ** significant at 1% level, * significant at 5% level.

Table 7.6 shows the results of the pooled regression models for 846 sample observations for the period 2000 to 2008 for each of the performance measures, using the SH_3 ratio as the measure of OC. The regression results indicate that a significant positive relationship exists between the OC ratio and accounting performance measures. The SH_3 variable is found to have a positive and significant impact on both ROA and ROE at the one per cent significance level.

Table 7.6 Estimates of Ownership–Performance using SH3 & F-Ind Variables

	ROA	ROE	TQ	MBR
Constant	−23.367	−44.474	1.461	1.132
	(−7.028)***	(−5.360)***	(7.641)***	(1.345)
OC-SH_3	0.080	.151	.001	.003
	(3.399)***	(2.588)***	(.841)	(.544)
Leverage (TD/TA)	−7.234	−3.103	.604	.311
	(−7.581)***	(−1.303)	(11.017)***	(1.287)
Age (LN-Age)	0.448	.805	−.007	.056
	(1.080)	(.779)	(−.289)	(.530)
Size (LN-TSal)	1.799	3.036	−.049	−.042
	(10.204)***	(6.901)***	(−4.843)***	(−.951)
Structure (F-Ind)	0.037	−.013	−.002	.005
	(2.111)**	(−.298)	(−2.167)**	(1.118)
No. of observations	846	846	846	846
R^2	.145	.067	.139	.005
Adjusted R^2	.140	.061	.134	−.001
F-stat	28.559	11.977	27.105	.760
P-value	0.000	0.000	0.000	0.579

Notes: *** significant at 1% level, ** significant at 5% level, * significant at 10% level. Numbers in parentheses are t-values.

However, the analysis of the impact of ownership concentration on market-based performance measures finds no significant positive relationship between variables. More specifically, SH_3 has no significant impact on both TQ and MBR and the estimated coefficients of SH_3 for all the models are close to zero, indicating an insignificant relationship between OC and market performance in Sri Lankan companies. This also implies the existence of market anomalies in Sri Lankan markets where market performance indicators may not necessarily reflect the company fundamentals.

Table 7.7 Estimates of Ownership–Performance using SH3 & F-Com Variables

	ROA	ROE	TQ	MBR
Constant	−19.690	−45.769	1.244	1.625
	(−6.556)***	(−6.107)***	(7.203)***	(2.137)**
OC-SH_3	.080	.151	.001	.003
	(3.399)***	(2.588)***	(.841)	(.544)
Leverage (TD/TA)	−7.234	−3.103	.604	.311
	(−7.581)***	(−1.303)	(11.017)***	(1.287)
Age (LN-Age)	.448	.805	−.007	.056
	(1.080)	(.779)	(−.289)	(.530)
Size (LN-TSal)	1.799	3.036	−.049	−.042
	(10.204)***	(6.901)***	(−4.843)***	(−.951)
Structure (F-Com)	−.037	.013	.002	−.005
	(−2.111)**	(.298)	(2.167)**	(−1.118)
No. of observations	846	846	846	846
R2	.145	.067	.139	.005
Adjusted R2	.140	.061	.134	−.001
F-stat	28.559	11.977	27.105	.760
P-value	0.000	0.000	0.000	0.579

Notes: *** significant at 1% level, ** significant at 5% level, * significant at 10% level. Numbers in parentheses are t-values.

The impact of ownership structure on firm performance is also tested based on the argument that larger individual ownership is positively related to firm performance, while larger corporate ownership is negatively related to firm performance. Table 7.6 and Table 7.7 show the results for regression models where F-Ind and F-Com is respectively used as the ownership structure variable. The results indicate strong evidence of a positive significant relationship between individual ownership (F-Ind) and ROA, and a significant negative relationship with corporate ownership (F-Com) and ROA. Both are significant at the five per cent level. This result is consistent with the argument that individual owners (compared to corporate owners) are actively engaged

in operational activities or are highly influential in monitoring the functions of firms. As a result, agency costs are expected to be reduced, resulting in higher performance; and the counter-argument is true for corporate ownership.

This study however finds conflicting results in relation to ROE and market performance measures. As shown in Table 7.6, the sign of the coefficients of F-Ind are negative with regard to ROE and TQ, while the coefficient is positive but non-significant for MBR. This suggests that either a negative relationship exists between F-Ind and performance, or that individual ownership is irrelevant to firm performance. As shown in Table 7.7, the corporate ownership (F-Com) has positive coefficients with ROE and TQ, contrary to expectations. The TQ coefficient is significant at the five per cent level. This implies that, although the controlling shareholder of a company is another corporate entity, its ultimate owners have reasonable influence on company affairs through indirect ownership. Furthermore, a larger fraction of corporate ownership does not necessarily indicate that a firm has a greater ownership concentration than with external investors. The existence of controlling ownership acquired directly or indirectly through another corporate entity, is a common feature of Sri Lankan companies. Therefore, ownership concentration with individuals (F-Ind) or with corporate entities (F-Com) does not necessarily have any significant distinguishable performance implications.

Table 7.8 presents the results of the pooled regression models for the same sample observations, where the HERF index is used as the measure of OC and F-Ind is used for the structure variable. The results indicate that the HERF index also has a positive and significant impact on both ROA and ROE at the one and five per cent levels respectively. This suggests that concentrated ownership plays a governing role in Sri Lankan firms in improving performance, through reducing agency costs by effective monitoring or direct involvement in management, as suggested by Jensen and Meckling (1976).

Furthermore, the other OC variable of the HERF index has a positive impact on both TQ and MBR at the five and 10 per cent significant levels. The coefficients of all models however, are close to zero, indicating a negligible impact. This strongly suggests that anomalies exist in Sri Lankan securities markets where economic and

company fundamentals are not reflected in share prices, restricting the ability of market prices to give a true picture of company performance.

Table 7.8 Estimates of Ownership–Performance using HERF & F-Ind Variables

	ROA	ROE	TQ	MBR
Constant	−19.125	−37.642	1.415	.914
	(−6.831)***	(−5.401)***	(8.838)***	(1.296)
OC- HERF	.001	.001	.000	.000
	(2.728)***	(2.560)**	(2.478)**	(1.932)*
Leverage (TD/TA)	−7.241	−3.097	.606	.317
	(−7.570)***	(−1.301)	(11.080)***	(1.313)
Age (LN-Age)	.385	.658	−.010	.044
	(.926)	(.635)	(−.430)	(.420)
Size (LN-TSal)	1.808	3.073	−.047	−.036
	(10.205)***	(6.966)***	(−4.668)***	(−.804)
Structure (F-Ind.)	.030	−.015	−.001	.008
	(1.707)*	(−.349)	(−1.285)	(1.898)*
No. of observations	846	846	846	846
R2	.141	.066	.144	.009
Adjusted R2	.136	.061	.139	.003
F-stat	27.609	11.946	28.366	1.449
P-value	0.000	0.000	0.000	0.204

Note: *** significant at 1% level, ** significant at 5% level, * significant at 10% level. Numbers in parentheses are t-values.

Table 7.9 Estimates of Ownership–Performance using HERF & F-Com Variables

	ROA	ROE	TQ	MBR
Constant	−16.166	−39.148	1.287	1.743
	(−5.759)***	(−5.603)***	(8.023)***	(2.465)**
OC- HERF	.001	.001	.000	.000
	(2.728)***	(2.560)**	(2.478)**	(1.932)*
Leverage (TD/TA)	−7.241	−3.097	.606	.317
	(−7.570)***	(−1.301)	(11.080)***	(1.313)
Age (LN-Age)	.385	.658	−.010	.044
	(.926)	(.635)	(−.430)	(.420)
Size (LN-TSal)	1.808	3.073	−.047	−.036
	(10.205)***	(6.966)***	(−4.668)***	(−.804)
Structure (F-Com)	−.030	.015	.001	−.008
	(−1.707)*	(.349)	(1.285)	(−1.898)*
No. of observations	846	846	846	846
R2	.141	.066	.144	.009
Adjusted R2	.136	.061	.139	.003
F-stat	27.609	11.946	28.366	1.449
P-value	0.000	0.000	0.000	0.204

Note: *** significant at 1% level, ** significant at 5% level, * significant at 10% level. Numbers in parentheses are t-values.

The impact of ownership structure is also tested with the HERF ratio, the results of which are given in Table 7.8 and Table 7.9. F-Ind and F-Com are respectively used as the ownership structure variables. These regression models also provide evidence of a positive significant relationship between individual ownership (F-Ind) and ROA, and a

significant negative relationship with corporate ownership (F-Com) and ROA. Both are significant at the ten per cent level. These models also reveal conflicting results in relation to ROE and market performance measures. Thus, the results confirm that ownership concentration of individuals (F-Ind) or of corporate entities (F-Com) do not necessarily have any significant distinguishable performance implications for Sri Lankan companies.

In all regression models, both firm size in terms of Total Sales and Firm Age have a positive impact on firm performance, measured by ROA and ROE. While Firm Size is significant at the one per cent level, Firm Age is not significant. Furthermore, leverage measured in TD/TA has a negative impact on both ROA and ROE. However, while the impact on ROA is significant at the one per cent level, ROE is non-significant. In general, the sign of the coefficients for control variables on ROA and ROE are inconsistent with previous findings and the economic arguments. However, both size and age have a significant negative impact on TQ; whereas the impact on MBR is not significant and leverage has a positive impact on TQ and MBR. These results are robust, and provide further evidence for the existence of market anomalies, which are inherent to most of the small emerging markets such as Sri Lanka.

The significant impact of the OC variables on ROA and ROE support Shleifer and Vishny's (1986) hypothesis that concentrated ownership might reduce agency costs, and hence increase firm performance. These results are also consistent with the claims made by Zeitun and Tian (2007); that ROA and ROE are the most important factors used by investors, not market measures of performance. This finding is also consistent with the results found by Wu and Cui (2002); that a positive relationship exists between ownership concentration and accounting profits, measured in terms of ROA. The insignificant results of concentration variables on both TQ and MBR could be due to the inefficiency of the Sri Lankan equity market, where company fundamentals are not impounded into share prices efficiently. The use of a proxy TQ might have aggravated the problem because accounting measurement problems are also imbedded into TQ, in addition to market inefficiencies. Both TQ and MBR are subjected to inherent market anomalies, such as insider trading and price fixing, which are common in small markets. Furthermore, other factors not considered in the model could affect market performance.

The empirical evidence suggests that ownership concentrated in individuals has a positive effect on performance measured by ROA, and a negative effect on performance if ownership is concentrated in corporate entities. However, the empirical evidence in respect of other performance measures, such as ROE, TQ and MBR show conflicting results. Despite the conflicting outcome, these empirical results support the assertion that a relationship exists between ownership structure and firm performance (Jensen and Meckling, 1976).

7.7 Summary

The academic literature mostly discusses corporate governance issues within the context of developed economies. Although corporate governance is identified as one of the structural weaknesses of emerging markets, less attention has been paid to various corporate governance issues in these markets. One governance issue that has attracted a large amount of attention in developed markets, but which has not been examined adequately in emerging markets, is whether ownership concentration and ownership structure can affect corporate performance. The studies conducted on this aspect in developed markets offer divergent results. Although some theories suggest that ownership structure affects firm performance, numerous empirical investigations suggest that performance implications of ownership structure are largely contextual. Because no prior studies exist on this issue in Sri Lanka — an emerging economy with unique social, cultural and economic settings—an objective of this study is to examine the impact of ownership concentration and structure on the performance of public listed firms in Sri Lanka. For this purpose, this correlation analysis and pooled data regression analysis carried out based on a sample of 157 Sri Lankan public listed firms for a nine-year period between 2001 and 2009, was undertaken. This study provides useful information on the relationship between various ownership concentration and structure measures and their influence on both accounting and market performance.

Empirical findings indicate that a significant relationship exists between ownership concentration, measured by SH_3 and the accounting performance measures ROA and ROE. The HERF index also has a positive and significant impact on both ROA and ROE. This result suggests that a greater concentration of shares leads to either effective monitoring of management behaviour or larger internal ownership, which results in better performance. However, ownership concentration did not show any

significant effect on market-based performance measures, which suggests the existence of market anomalies and inefficiencies which are common to most emerging markets such as Sri Lanka.

An examination of the impact of ownership structure on performance provides evidence that share ownership fractions have a significant effect on ROA. However, all other performance measures show conflicting results in respect of the sign of the coefficients or significance thereof. These results provide evidence for a pattern of share ownership in Sri Lankan firms, for most of which, the ultimate controlling share ownership lies in the hands of families or business conglomerates acquired through individuals or other corporate entities. Therefore, the fraction ratios, measured as the percentage of shares owned by individuals, and the percentage of shares owned by other corporate entities do not have any significant distinguishable effects on performance.

The scope of this study is limited to an examination of the ownership concentration and structure measured in terms of direct shareholdings without analysing ultimate ownership. However, given the nature of ownership structure in Sri Lankan companies, ultimate ownership which is acquired either directly or indirectly could have significant impact on performance. However, due to the limitation on indirect ownership data, only direct ownership is considered in the study. While outside the scope of this thesis, future studies should therefore extend the definition of ownership beyond direct shareholdings to examine the impact of ultimate ownership on firm performance. Another limitation of this study is the use of pooled data regression analysis, which assumes that the intercept and slope coefficients are constant across time and sectors.

Chapter 8 : SUMMARY, FINDINGS AND CONCLUSION

8.1 Introduction

Studies which examine the suitability of prevailing corporate governance best practices around the world have increased considerably since the collapses of a large number of well-known companies. Corporate governance is particularly important for emerging markets to secure economic development and to avoid economic crisis. However, studies investigating the suitability of existing corporate governance practices for emerging markets are relatively few compared to those conducted on developed markets. Sri Lanka, being an emerging market, is not an exception. Sri Lankan corporate governance practices are largely influenced by corporate governance codes developed in U.K. and other developed economies. The suitability of these corporate governance practices developed in Anglo-Saxon countries and promoted to Sri Lankan companies is questionable, as no systematic research has been done to examine their validity in an emerging market context. Therefore, an objective of this study is to fill this gap by examining the compliance of corporate governance best practices by Sri Lankan companies with ownership implications, and to analyse this issue from stakeholders' points of view.

In summary, this study contributes a comprehensive literature review on corporate governance (refer Chapter 2) giving an insight into previously identified corporate governance issues of both developed and emerging markets. The historical developments of corporate governance in Sri Lanka, together with its legal and institutional framework are discussed in Chapter 3, placing this study in the Sri Lankan context. The research design and the methods adopted in empirical examinations are discussed in Chapter 4. On the basis of data obtained from a questionnaire survey, Chapter 5 provides an analysis of compliance to corporate governance best practices by Sri Lankan companies. In doing so, a bespoke corporate governance index is constructed with eight sub-indices, examining the comparative levels of compliance with corporate governance best practices by Sri Lankan companies, and to examine the impact of such compliance on firm performance. Chapter 6 focuses on the perceptions of various stakeholders of corporations, on the basis of questionnaire survey data regarding prevailing corporate governance issues and as to how those issues should be addressed in the Sri Lankan context. As ownership concentration is a common

characteristic of most Sri Lankan companies, Chapter 7provides an analysis of the impact of ownership concentration on firms' performance. The main purpose of this chapter is to discuss the findings of various aspects of corporate governance analysed in the previous chapters and to present conclusions of this study. On the basis of these findings and the conclusions, this chapter also makes recommendations for the improvement of corporate governance practices in Sri Lanka.

8.2 Summary of Findings

8.2.1 Compliance to Corporate Governance Best Practices

Compliance to corporate governance best practices by Sri Lankan listed companies is examined based on data collected from a questionnaire survey carried out amongst CEOs and the chairmen of sample companies. This is carried out to achieve four specific objectives. First, the nature of compliance to best corporate governance practices is evaluated using percentage and frequency analysis. Secondly, the level of compliance to corporate governance practices is assessed using a corporate governance index developed based on questionnaire survey data. As it is expected that the concentration of ownership of family, foreign or controlling owners could have a significant impact on corporate governance compliance by firms, impacts of such ownership concentration is examined in the third section. Finally, the impact of compliance with corporate governance practices on firms' performance is examined using index scores and financial and market performance variables.

8.2.1.1 Nature of Compliance to Corporate Governance Best Practices:

In order to find out the nature of compliance of best corporate governance practices by Si Lankan listed companies, an analysis of the questionnaire survey results is carried out across eight dimensions. Following are the major findings of this analysis:

(1) **Board Size, Structure and Independence:** The size of boards varies from six to ten members with an average of 75 percent of NEDs for the companies under review. Although the majority of companies have independent directors, 24 per cent of them have lower than the mandatory number of independent directors. The boards of directors seem to be average in size with a high proportion of NEDs, but with few independent directors. This suggests that despite having a high proportion of NEDs on boards, board functions are not adequately monitored by independent directors in most companies. The size of the board should be large enough to secure

sufficient expertise on the board. Nam and Lum (2005) argue that the most effective size of a board for corporate governance purposes is no more than twelve members. Salmon (2000) claims that a board is likely to have difficulty in staffing board sub-committees if its members are fewer than eight. The size of the boards of Sri Lankan companies is likely to be large enough for adherence to best corporate governance practices in terms of securing expertise and staffing board sub-committees.

Although, the majority of companies (75%) have separate persons for the Chairman and the CEO positions, non-controlling shareholders and institutional investors are generally not adequately represented on boards. Insufficient representation of independent directors and inadequate representation of non-controlling shareholders and institutional investors on boards are common issues faced by the majority of companies. The true independence of independent directors is rather doubtful, judging from selection processes, as selected independent directors and NEDs are determined by either the CEO or controlling shareholders in approximately 30% of companies surveyed. Such compositions of boards and the selection processes of directors can have negative implications for boards' independence, with a strong possibility board's decision making processes could be centralized towards the CEO's or controlling shareholders' views. Hence it is inferred that not only the composition of boards, but also the selection process of directors can have negative implications on the independence of the boards.

(2) **Board Procedure and Effectiveness:** The board practices and meetings, board committees, appointments, and performance evaluation of directors are analysed in this aspect. The results show that a majority (92%) of respondent companies has recorded dissenting views in their minutes, and over 90 per cent of the boards have a schedule of matters reserved for consideration. However, 40 per cent of boards do not have bylaws to govern board meetings and the majority of boards (57%) do not conduct separate meetings of non-executive directors. Although most companies have audit and remuneration committees, only 45 per cent of companies have established nomination committees. Inactive functioning of nomination committees (63% met once a year) has aggravated the problem of the low prevalence of nomination committees. For example, only 37 per cent of companies made

appointments to the boards through their nomination committees. It is implied that the CEO or controlling shareholders dominate in board appointments.

The boards seem to be somewhat inactive in monitoring and replacing CEOs and evaluating performance of directors. For example, a majority of companies (60%) do not evaluate performance of directors individually. Although a majority of companies evaluate performance of CEOs (58%) and executive directors (50%), only 23 per cent evaluate NEDs' performance. Non-executive and independent directors are inadequately supported with education and training. A majority of companies (62%) do not provide training opportunities for newly appointed directors. Further, 57 per cent of companies do not have a written code of conduct and ethics for directors. The insufficient number of independent directors on boards, their selection by CEOs or controlling shareholders, and a lack of support for and evaluation of independent directors, raises serious doubts about the true independence of independent directors of Sri Lankan companies.

(3) Directors' Remuneration: Although most companies have established remuneration committees, 50 per cent of companies do not have proper remuneration policies for directors. Further, 33 per cent of companies do not have written terms of reference for governing the activities of remuneration committees. Stock options and other forms of performance based remuneration components for CEOs and directors are a rare occurrence in Sri Lankan companies. Thus, the performance of an individual director or the company is not a limiting factor for directors to receive regular remuneration. Only 13 per cent of firms compensate their CEO using stock options, suggesting that share market performance is not a deciding factor for CEOs to secure their remuneration. As the directors and CEOs are not at risk of losing their remuneration for poor firm performance, there may be a lack of motivation for them to perform in the best interests of shareholders. This could have a negative impact on firm performance, leaving shareholders at risk.

(4) Audit committee procedure: A relatively higher compliance level is observed on the practices of audit committees in comparison to the practices of nomination and remuneration committees. All companies surveyed have audit committees. The results show that both composition and processes of audit committees of the

majority of companies have satisfied the requirements of corporate governance regulations. The audit committees of a majority (92%) of sample firms are chaired by an independent director, and 88 per cent of the firms had committees comprising a majority of independent directors. The survey results further show that 97 per cent of the firms have an accounting professional on the committee. Over 80 per cent of companies comply with the recommended processes of audit committees such as having terms of reference, circulating committee minutes, meetings with external auditors, and making recommendations to their board for the appointment of external auditors.

(5) **Disclosure and transparency:** The analysis shows that over 60 per cent of firms surveyed disclose financial information on their website. However, less than 20 per cent of firms regularly disclose on their websites price sensitive information such as: related party transactions; directors' share dealings; the resume or background of directors; directors' remuneration; policies on risk management; audit and non-audit fees; memberships of sub-committees; and, committee reports, indicating most companies are reluctant to disclose information voluntarily. Such a lack of disclosure has a negative effect on corporate governance practices (Susilowati et al., 2005). Thus, promoting disclosures of information directly related to directors' affairs and other price sensitive information should be given priority by policy makers.

(6) **Disclosure reliability:** The reliability of financial disclosures is largely dependent on external auditor's independence. Results show rotation of audit partners (68%) and the review of external auditors' works by the audit committees (88%) are carried out by a majority of companies indicating that they take reasonable efforts to maintain the independence of the auditor. However, 58 per cent of firms obtained non-audit services from their external auditor, suggesting a negative impact on auditors' independence.

(7) **Shareholders' Rights:** Shareholders' rights, such as voting in shareholders' meetings, appointing proxies, appointing the board members, timely receipt of information, and the presence of chairpersons of sub-committees at the AGM, are respected by the majority of surveyed companies. This is primarily due to the availability of elaborate regulations on shareholders' rights and the procedure of

shareholders' meetings prescribed in *The Companies Act* and the SEC regulations. Nevertheless, there is substantial room for improvement. Voting by mail and shareholders' priority subscription rights are not protected by most companies. The shareholders of 90 per cent of companies surveyed did not request an extraordinary meeting in last 3 years. Given the high ownership concentration in most companies, the ability of non-controlling shareholders to address their concerns by calling a special shareholders' meeting seems to be difficult.

The average duration of the AGM is less than one hour for 65 per cent of firms surveyed. It is noted that average voting participation in the AGM is less than 10 per cent for one third of the sample firms. Only 30 per cent of companies have shareholder voting participation above 80 per cent. Given that most firms have controlling shareholders with a high concentration of ownership, the fraction of voting rights exercised at AGMs is significantly low. The restriction on voting by mail undermines the rights of shareholders, and this could have aggravated the low voting rights exercised at AGMs. The voting behaviour and length of the AGM suggests that non-controlling shareholders do not often actively participate in the process of selecting board members and other AGM activities.

(8) Related Party Transactions: The problem of not having enough provisions in the SLCGC is clearly evident from the diverse practices adopted by Sri Lankan companies, especially with regard to the approval of RPTs. The execution of RPTs requires only minimum levels of approval for most companies. None of the surveyed companies requires shareholder approval to execute major RPTs suggesting dominant shareholders influence the affairs of Sri Lankan companies. For example, 15 per cent of respondents state that their companies do not require specific approval to carry out RPTs, and 35 per cent of companies require only CEO approval to perform RPTs. Over 95 per cent respondents stated that their companies do not require either non-conflicted directors or audit committee approval to execute RPTs. The lack of independence in the boards and the presence of controlling shareholders in most Sri Lankan companies are likely to aggravate the negative effects of RPTs. This evidence suggests that non-controlling shareholders are at great risk of losing their investments. Thus, these factors should

be given more attention by policy makers in developing best governance practices for RPTs.

Salient Features of Corporate Governance Practices: Under this category both positive and negative features are identified based on the nature of compliance of corporate governance best practices by sample companies. The 'positive features' represent the items of best practice with which the majority of sample companies have complied, and non-compliance items are represented in 'negative features'.

The positive features are as follows: the availability of a clear role for the board to play as there is a formal schedule of matters reserved for its decision making; adequate representation of NEDs on the board; separate persons for the CEO and the chairman; the submission of the majority of directors for re-election at regular intervals; conduct of regular board meetings; recording of dissents in the board minutes; the availability of directors with financial acumen on the board; the succession planning of directors and senior management; the existence of an audit committee and remuneration committee; the formulation of terms of reference of board committees; the appointment of an audit committee and its membership consisting of non-executive directors with necessary financial expertise and experience; the availability of a clearly defined role, responsibility and authority of the audit committee; regular conduct of audit committee meetings; the evaluation of executive directors' and CEO's performance annually; the provision of information to directors for decision making on a timely manner; the availability of proper procedures for a remuneration committee; review of external auditors' work by an audit committee; the rotation of audit partners in every 5 years; review of audit recommendations by the board; allowing anybody to serve as a proxy; the presence of chairpersons of sub-committees at the AGM; the execution of RPTs at arm's length terms; and, the review of RPTs by the board.

The negative features are as follows: a lack of independent non-executive directors on boards; a lack of independent members on board subcommittees; insufficient representation of institutional and non-controlling shareholders on boards; the presence of controlling shareholders' family members on boards; the appointment of NEDs by the CEO or controlling shareholders; the absence of bylaws to govern board meetings;failure to conduct separate meetings of NEDs; insufficient performance

evaluation of directors; low prevalence of nomination committees; inactive functioning of nomination committees; not limiting the number of directorships that can be held by a director; insufficient board appointments through nomination committees; the failure to conduct annual performance evaluations of NEDs; a lack of attention paid to maintaining written codes of conduct and ethics for directors; insufficient attention paid to the professional development of directors; insufficient training provided to newly appointed directors; insufficient written policies on directors' remuneration; insufficient performance-based remuneration packages for executives; non-provision of share options for CEO and NEDs; a lack of voluntary disclosures on company websites; obtaining significant amounts of non-audit services from external auditors; not allowing voting by mail; insufficient provisions to protect shareholders' priority subscription rights; exercising low voting rates at AGMs; not having an AGM for a reasonable duration; insufficient provisions of appropriate approval levels to execute RPTs; not obtaining audit committee or non-conflicting directors' approval for RPTs; and, lack of transparency in relation to disclosures of directors' remuneration.

8.2.1.2 Level of Compliance of Corporate Governance Best Practices:

The third objective of this study is to examine the level of compliance with corporate governance best practices in terms of corporate governance scores calculated based on the CGI. The CGI is developed with eight sub-indices representing the eight dimensions of corporate governance examined in the study. The maximum possible overall score for the CGI is 90, which is the addition of the maximum marks of each of its eight sub-indices. The distribution of corporate governance scores and descriptive statistics of the overall index and sub-indices are analysed to find out overall behaviour indicated by the index scores. As the compliance to governance practices can significantly vary across the nature of family ownership and foreign ownership, and the presence of controlling shareholders, the level of compliance is analysed across these dimensions of ownership.

(a) **Overall Level of Corporate Governance:** The descriptive statistics of the CGI and the sub-indices show that the mean value of the overall CGI is 61.17 (68%) and the mean values of sub-indices vary from 58% to 85%. The distribution analysis of CGI scores show that none of the companies obtained an average score of 90 per cent or more. However, scores of the sub-indices show that the majority of

companies have better compliance with audit committee procedures, shareholders' rights, and directors' remuneration procedure dimensions, with mean values of over 80%. The RPTs and board procedure and effectiveness are the least complied with dimensions of overall corporate governance practices. The mean value of the scores of these sub-indices is 58% each. The descriptive statistics of scores of the CGI show that there are substantial variations of compliance with governance practices by Sri Lankan companies, ranging from a minimum score of 39 to a maximum score of 80. This behaviour raises the question of whether there are dominant factors which determine the level of corporate governance compliance of companies.

(b) **Comparative Analysis of Sub-Indices Scores across Three Ownership Dimensions:** Having observed the significant variations of sub-indices scores amongst the companies in the overall sample, the study identified a primary cause for these variations. The concentration of ownership either with family owners, foreign owners or controlling owners is a common feature of most Sri Lankan companies. Thus, the comparative analysis of sub-indices scores are carried out across three dimensions of ownership namely: family ownership; foreign ownership; and, controlling ownership.

The results reveal that the level of compliance to best corporate governance practices by FB companies is relatively low across all corporate governance dimensions measured in the sub-indices. The average CGI score of FB companies is 62 per cent compared to 72 per cent of NFB companies. Furthermore, the FB companies have significantly lower levels of scores in three sub-indices compared to those of NFB companies. The sub-indices scores of BPE (49% against 64%), ACP (78% against 90%), and DS (58% against 72%) show significant variation between these sub samples. This indicates that family ownership exerts a significant negative influence on board procedure practices, audit committee procedures, and financial disclosures practices. In contrast to family ownership, foreign ownership constantly results in a positive influence on compliance with corporate governance best practices across all dimensions considered in the study. The average CGI score of SFO companies is 76 per cent compared to 69 per cent of LFO companies. This indicates compliance to governance practices is positively influenced by the

presence of foreign owners. The presence of controlling shareholders is a common occurrence for most Sri Lankan companies surveyed. The results show that the presence of controlling shareholders has a negative effect on compliance with corporate governance practices across all dimensions examined in the study.

(c) **Comparative Analysis of Individual Corporate Governance Practices Across three Ownership Dimensions:** The results of a comparative analysis of sub-indices' scores across three ownership dimensions (refer Section 5.5.2.1) provide prima facie evidence that family ownership has a negative influence on governance practices, whereas foreign ownership has a positive influence on governance practices. Further, it shows that the presence of controlling shareholders has a negative impact on corporate governance practices. In order to find out whether individual practices also have similar behaviour, a comparative analysis of each individual practice is carried out. The analysis of the scores of each individual practice of CGI (refer Section 5.5.2.2) provides a detailed account of the level of compliance of two corresponding sub- samples across three ownership dimensions examined in the study. This analysis shows that non-family based companies have complied better than family based companies in relation to almost all individual items. A similar observation is made in relation to other ownership dimensions too. These results confirm that the ownership of a company has direct impact on their compliance with corporate governance best practices.

8.2.1.3 Impact of Ownership on Level of Corporate Governance Compliance:

Objective four examines the impact of ownership on the level of compliance with corporate governance requirements and recommendations. The comparative analysis of sub-indices scores and individual practices across sub samples of each ownership dimension indicates that ownership influences the level of compliance with corporate governance best practices. This impact is statistically verified using a t-test for the independent sample, for the purpose of discovering whether there is a statistically significant difference between the subsamples regarding the compliance level.

(a) **Impact of Family Ownership:** The results show that the level of corporate governance compliance of FB companies is lower than that of NFB companies, as indicated by the negative mean differences in scores of all sub indices and the CGI. The t-test results show that the negative mean difference is statistically significant

at the 1% level for the CGI. The scores of sub indices show that family ownership has a statistically significant negative impact on: board procedures; firms' voluntary disclosures; audit committee procedures; and, directors' remuneration procedures.

(b) Impact of Foreign Ownership: The results show that there are positive mean differences in scores of the CGI and the sub indices indicating the level of corporate governance compliance of SFO companies is higher than that of LFO companies. The positive mean difference for the CGI is statistically significant at the 1% level indicating that foreign ownership has a significant positive impact on compliance to corporate governance regulations and recommendations. The statistically significant results of sub indices provide further evidence that board procedures, audit committee procedures, and disclosure requirements are better complied with by foreign owned companies compared to their counterparts.

(c) Impact of Controlling Ownership: The results show that there are negative mean differences in scores of all sub indices and the CGI indicating the presence of controlling shareholders is detrimental to establishing effective governance practices. Furthermore, the statistically significant negative mean differences of BSI and RPTs sub indices indicate that the presence of controlling owners has a negative impact on board independence and related party transactions. This result suggests that non-controlling shareholders of these companies are exposed to a higher level of risk than controlling owners, through the expropriation of company resources by controlling owners.

8.2.1.4 Impact of Corporate Governance Compliance on Firm Performance:

Objective five examines the impact of compliance to corporate governance practices on firms' performance, proposing that a higher level of compliance will enhance firm performance. The level of compliance is measured by the scores of CGI. High and low compliance sub samples are identified using the cut-off index score of 61, which is the mean value of the overall sample. The financial performances considered in the study are Return on Assets (ROA) and Return on Equity (ROE) while market performances are Tobin's Q (TQ) and Market to Book Value (MBR). The analysis addresses two issues: whether higher levels of corporate governance compliance improve firms' financial performance; and, whether the higher levels of corporate governance compliance improve market performance of Sri Lankan companies. The

impact is statistically verified using correlation analysis and a t-test for an independent sample.

The impact of corporate governance on firm performance shows mixed results. Higher levels of compliance have a significant positive impact on financial performance measures, indicating better corporate governance leads to better operating and financial performance of Sri Lankan companies. The market performance measures show, however, a negative relationship with corporate governance compliance. This may be due to market anomalies such as insider trading and price manipulations, which prevail in the Sri Lankan stock market.

8.2.2 Stakeholders' Perceptions on Corporate Governance

Objective six of the study is to examine the perceptions of various stakeholder groups on the present status, main issues, strategies and practices of the corporate governance system of Sri Lanka. This is achieved by examining the perceptions of seven stakeholder groups through an analysis of data collected from a questionnaire survey conducted in Sri Lanka in early 2010. Six hundred and sixty five questionnaires were distributed among seven stakeholder groups namely: NED (150), IAP (70), ACC (125), GPM (80), GATO (100), ACD (40), and INV (100). The study uses a questionnaire with 70 questions on a 5-point Likert scale (1 = strongly disagree; 5 = strongly agree) to collect primary data from these stakeholder groups about their perceptions on eight aspects of corporate governance in Sri Lanka. Further, respondents were asked to answer two open ended questions regarding major problems and recommendations of corporate governance in Sri Lanka. The total number of usable responses to the questionnaire amounted to 277, giving a response rate of 42 per cent. The test conducted to investigate the non-response bias indicated that there was no such bias. Thus, the responses can be regarded as a representative sample of the population. The analysis of the profile of respondents reveals that the majority of respondents have high level of education (85% with tertiary education), professional education (78% with professional qualifications), work experience (53% with over five years work experience), and share investment experience (43% invested in shares). Thus, the respondents are well qualified to make independent judgments regarding corporate governance issues addressed in the survey.

The analysis addresses the stakeholders' perceptions on eight aspects of corporate governance system in Sri Lanka. The Kruskal-Wallis test is carried out to examine whether there are significant differences between opinions of stakeholder groups. Following are the major findings of this analysis:

(1) In order to understand the importance given to various components of the Sri Lankan corporate governance system, the respondents were asked to indicate their extent of agreement with given components as an important aspect of the corporate governance system of the country. The findings of the study reveal that a majority of stakeholders consider governance codes, the financial reporting framework, the regulatory framework, and codes of conduct and ethics as important components of corporate governance system. However, the importance given to the judiciary system, corporate ownership structure, and culture and value systems of the society as components of the corporate governance system is relatively low. The corporate governance codes and financial framework of the country are considered as the most important components whereas the judiciary system is considered as the least important component. This suggests that the respondents put more emphasis on financial aspects rather than on legal enforcement to instil sound corporate governance practices in Sri Lanka. However, it was found that the degree of importance placed on the seven components listed in the questionnaire varied significantly across stakeholder groups, indicating these groups have different opinions as to what aspects should be given priority in policy making.

(2) Stakeholders' opinions on the performance implications of corporate governance compliance reveal that the majority of respondents consider better corporate governance improves financial, market and corporate social performance, and increases the ability to access new capital. However the majority of respondents believe that political interventions and share price volatility cannot be minimized in Sri Lanka by improving its corporate governance system. The Kruskal-Wallis test results also show that the stakeholder groups have different opinions on whether the better corporate governance can improve market performance and the ability to generate new capital. These findings are consistent with the corporate governance survey results which show that high compliance with corporate governance

recommended and regulated practices cannot improve the market performance of the company (refer Section 5.6).

(3) Stakeholders' opinions on the present status of corporate governance reveals that a majority of respondents are extremely dissatisfied with the various aspects of the corporate governance system in Sri Lanka, believing that it is not comparable to that of a developed country. The majority of respondents strongly disagreed with the adequacy of existing corporate governance regulations and protection of minority shareholders' rights in Sri Lanka. Furthermore, they are of the view that the implementation and monitoring are also not adequate. The differences in opinion of most items are not significant. This suggests the shareholder groups collectively agree that the present status of Sri Lankan corporate governance is not up to their expectations.

(4) The analysis of stakeholders' perceptions on various issues of corporate governance reveals that all the given issues such as: a lack of integrity; inadequate transparency; a lack of independence of independent directors; insider trading; inadequate protection of minority shareholders; and, conflicts of interest of directors are considered as major issues by a majority of respondents. This result is consistent with the survey results (refer Section 8.2.1.1.) which show that the practices recommended to avoid these issues are not fully embraced by most companies. Thus, corporate governance policy makers should pay more attention to these issues in formulating and standardizing governance practices.

(5) It is also found that the majority of respondents agree that the given corporate governance strategies of: improving internal and external governance mechanisms; conducting corporate governance ratings of companies; controlling some types of RPTs; and, enhancing accounting and auditing standards are suitable to improve the efficiency of corporate governance practices. However, changing ownership concentration is not accepted as an effective strategy by the majority of respondents. It suggests that the market has accepted the very nature of ownership in Sri Lankan companies and therefore policy makers need to pay attention to other strategies and practices which are capable of controlling adverse effects of ownership concentration, instead of having legal restrictions on ownership.

(6) In order to understand the importance of corporate governance practices which are capable of enhancing corporate governance in Sri Lanka from the stakeholders' point of view, the respondents were asked to indicate the extent of importance they place on each of the given governance practices. The results identified three levels of importance placed by the respondents. The practices which received the greatest level of importance from the respondents are: giving greater power to audit committees; full disclosures of RPTs; the separation of the CEO and chairman positions; independent NEDs; and, adoption of codes of conduct and ethics. The practices in the second level are: not obtaining audit and non audit services from the same provider; closely tying remuneration of executive directors to performance; composing key advisory committees entirely of independent directors; fully disclosing the recruitment and remuneration policies of directors; and, imposing limitations on the number of directorships held by a director at any time. The practices which received the least level of importance are: board composition comprising at least half independent directors; disclosing exact remuneration of directors in annual reports; and, setting an age limit for directors. It suggests that the market as a whole agreed that the board independence, ethical practices and controlling RPTs are important aspects to be given high priority by policy makers in formulating corporate governance practices.

(7) In order to understand the efficiency benefits to organizations which carry out various functions of corporate governance, the respondents are asked to express their views on whether these organizations carry out their role efficiently in promoting good corporate governance in Sri Lanka. All organizations under review received low scores indicating they do not carry out their roles efficiently to satisfy stakeholders' expectations. However, the organizations such as the SEC, CSE and ICASL received relatively better acceptance compared to other organizations. The judiciary, Sri Lanka Institute of Directors, outside directors, civil activists and the media received low levels of acceptance, indicating that the roles played by these organizations/groups in enhancing corporate governance in Sri Lanka are not adequate to satisfy the expectations of the market.

(8) The majority of respondents prefer the prevailing balanced approach to corporate governance regulation, consisting of both mandatory and voluntary practices, as

most suitable to promote good governance practices in Sri Lanka. This suggests the importance of encouraging regulatory enforcement, and securing flexibility in business operations.

(9) When the respondents were given the opportunity to comment on perceived corporate governance problems in Sri Lanka, they recognized a number of issues based on their experience and expertise. After classifying these issues into several themes, it is revealed that: a lack of education and awareness of corporate governance; insufficient regulations and regulatory enforcement; a lack of integrity and independence of directors; insufficient ethical standards; a lack of transparency; ownership concentration; and, political interventions, insider trading and corruption are most recognized as problems in Sri Lanka.

(10) Respondents were given an opportunity to make recommendations to improve corporate governance in Sri Lanka. These are classified into five themes, namely: strict regulations and regulatory monitoring; sufficient education for board members and senior management; more emphasis on judiciary enforcement; increased ethical standards; and, prevention of political intervention.

8.2.3 Impact of Ownership Concentration on Firm Performance

Objective seven of this study is to examine the impact of ownership concentration on firms' performance. This is achieved by examining the relationship between ownership concentration and performance data of listed companies in Sri Lanka. The sample includes companies in all industrial sectors of the CSE, excluding the bank, finance and insurance sector for the period of 2001 to 2009. The final sample consists of 157 companies which is approximately 68 per cent of the listed companies of the CSE. The final data set consists of 846 firm-years for the entire sample period. The OC variables are: the percentage of shares held by first three(SH_3), first five (SH_5) and first ten (SH_{10})largest shareholders; and, the HERF Index. The OS is measured using two fraction ratios: the fraction owned by individuals, and the fraction of shares owned by institutions. ROA and ROE are employed as the accounting performance measures, while the proxy TQ ratio and MBR are used as the market performance measures in the study. Several control variables were also employed in the analysis to control the size, age and leverage of the sample companies.

Correlation analysis and the pooled data regression analysis are used to measure the impact of ownership concentration on firm performance. The analysis is carried out on the premise of agency theory, which argues ownership concentration and individual share ownership make positive impacts on firm performance. This study provides useful information on the relationship between various ownership concentrations and structure measures, and their influence on both accounting and market performance. Following are the findings of this analysis:

The descriptive statistics show that all SH ratios indicate a high ownership concentration in the sample of Sri Lankan companies. The mean values of SH_3 ratio is 70 per cent while it is 84 per cent for SH_{10} ratio. The data reveal that that ownership of Sri Lankan companies is highly concentrated and the ten-largest shareholders of some companies held over 75 per cent of total share capital. This indicates that these firms are not compliant with the CSE listing rule requirements which stipulate that a minimum float of 25 per cent shares should be held by at least 1,000 shareholders. While the results of this study suggest that Sri Lankan firms have high OC, the OS of firms as measured by fraction ratios, indicates the average proportion of shares held by a corporate entity (72%)is high compared to individual ownership (28%).

Correlation analysis results show a significant relationship between firm performance and OC variables. The SH_3ratio is positively correlated to ROA, ROE and TQ, but it is negatively correlated with MBR indicating market anomalies prevailing in the Sri Lankan market. The correlation of ownership structure variables with performance variables show mixed results. F-Ind ratio is positive for ROA but it is negative for ROE and TQ. The claim that higher individual ownership leads to higher firm performance whereas higher corporate ownership leads to poorer firm performance is not supported by the results.

Regression analysis results indicate that a significant relationship exists between the SH_3ratio and the accounting performance measures of ROA and ROE. The HERF index also has a positive and significant impact on both ROA and ROE. This suggests that concentrated ownership plays a governing role in Sri Lankan firms in improving performance, through reducing agency costs by effective monitoring or direct involvement in management, as suggested by Jensen and Meckling (1976).However,

ownership concentration did not show any significant effect on market-based performance measures, which suggests the existence of market anomalies and inefficiencies which are common to most emerging markets.

An examination of the impact of ownership structure on performance provides evidence that share ownership fractions have a significant effect on ROA. However, all other performance measures show conflicting results in respect of the sign of the coefficients or significance thereof. The fraction ratios, measured as the percentage of shares owned by individuals, and the percentage of shares owned by other corporate entities do not have any significant distinguishable effects on performance. This may be due to the use of only direct ownership in the study, without analysing the ultimate ownership of companies.

8.3 Conclusions and Recommendations

The following conclusions are made based on: the analysis of relevant literature; the results of questionnaire surveys on levels of compliance; the stakeholders' opinions on corporate governance practices; and, findings about the impact of ownership on firm performance in the form of answers to stated research questions.

(1) What is the historical development and current status of corporate governance in Sri Lanka?

The history of corporate governance in Sri Lanka dates back to its period under the British regime. The introduction of English company law and the commencement of share trading activities by the CBA are major contributing factors to the development of corporate governance of Sri Lankan companies in the colonial era. The fundamental corporate governance framework of the country during this period was provided by the provisions of the *Companies Ordinance* and the listing rules and guidelines stipulated by the CBA. In the post colonial period and after 1977, interest in corporate governance re-emerged with the introduction of open economic policies. The development of capital markets and influences of the international funding agencies such as the World Bank and the IMF, who advocate a market based model, also contributed to the development of the regulatory and institutional framework for corporate governance. Thus, development of corporate

governance requirements was influenced by both historic and economic factors, resulting in them showing characteristics of the Anglo-Saxon model.

The existing corporate governance framework of Sri Lanka is a mixture of government intervention through statutes (e.g. the *Companies Act*, *SEC Act*, and the *Accounting and Auditing Standards Act*), and professional accounting institutions' interventions through their development of voluntary corporate governance codes. Thus, these requirements are now governed by the provisions of Companies Law, SEC Rules, CSE Listing Rules, the SLCGC (2008) and supplementary codes on corporate governance. Amongst these, the corporate governance codes play a dominant role in recommending detailed corporate governance practices. However, these codes are not mandatory and therefore considerable freedom is enjoyed by the management if firms in applying these recommendations. Although some mandatory rules on corporate governance are incorporated into the Colombo Stock Exchange (CSE) Listing Rules of 2007, their coverage is limited in aspects of corporate governance. Two additional mandatory codes were issued in 2009, but these are limited to banking and finance sector companies. Despite these limitations, the introduction of corporate governance requirements into listing rules and sector specific mandatory codes can be considered as encouraging features of recent developments of corporate governance in Sri Lanka.

Despite these developments, all Sri Lankan codes were devised primarily based on British codes. For example, *The ICASL Code* (2003) was developed based on *The Combined Code* (1998) and *The Code* (2008) was adopted from *The Combined Code* (2003) of the U.K. As a result, corporate governance practices implemented in developed economies were introduced to Sri Lanka without proper evaluation of their suitability. These codes were developed on the assumption that ownership and control of corporate entities are separated, and therefore they are largely focused on the responsibilities, structure and organization of the board with the aim of improving its monitoring role. Sri Lankan companies however, experience high ownership concentration and therefore the corporate governance codes produced in developed markets have limited applicability to Sri Lankan companies. For example, the results of the corporate governance survey (refer Section 5.5.2) show that the compliance levels of foreign owned companies was significantly higher

than that of ownership concentrated companies and family owned companies. Thus, policy makers should be more attentive to ownership structure and other characteristics of Sri Lankan companies in developing corporate governance codes.

Although Sri Lankan company law was amended consistent with changes to British company law, the local law did not keep pace with its British counterpart. The *Companies Ordinance No.51 of 1938* was enacted based on the English Companies Act of 1929. Until the *Companies Act No.17 of 1982* was enacted based on the English *Companies Act of 1948*, the *Companies Ordinance of 1938* remained as company law in Sri Lanka. The *Companies Act 2007* of Sri Lanka has many provisions that encourage good governance practices. However, until enacting this Act in 2007, Sri Lankan companies were governed by the older Companies Act No.17 of 1982, which was adapted from UK Companies Act of 1948. In spite of immense changes in the business environment in Sri Lanka, especially after the introduction of open economic policies in 1977, until 2007 Sri Lankan businesses were governed by an Act virtually 60 years old. This allowed various regulatory lapses to creep into business practices.

Limitations in the legal system have implications for the governance structure of Sri Lankan companies. La Porta et al. (1998) assume that the legal system is a fundamental to a corporate governance mechanism. They argue that the evolution of corporate governance in a country is determined by the availability and proper enforcement of law which protects the rights of investors. They claim that concentrated ownership is a necessary condition in countries without strong protection for investor rights, as it gives power to shareholders to monitor and control managers. The delay in enforcing new company law with adequate provisions to protect investors' rights could have contributed to ownership concentration in Sri Lankan listed companies. Further it is revealed (refer Section 5.5.2) that ownership concentration has a negative impact on the compliance of corporate governance practices of these companies.

(2) What is the nature and level of compliance maintained by Sri Lankan companies in respect of the corporate governance best practices?

Variations in CGI scores (ranging from 43 per cent to 88 per cent)indicate that there are significant differences in compliance levels by Sri Lankan companies to corporate governance best practices. Furthermore, scores of sub indices indicate levels of compliance with different aspects of corporate governance vary significantly. Recommended audit committee procedures, shareholders' rights, and directors' remuneration procedures are better complied with compared to compliance with recommendations for RPTs, and board procedure and effectiveness aspects. This is indicated by the range in mean values of their sub-indices (58 per cent to 85 per cent).As companies voluntarily comply with the requirements of best practice, the variation in index scores indicates divergence in companies' interests in and commitments to compliance. Results suggest that while some companies are compatible with practices originating from the Anglo-Saxon model, poorly compliant companies indicate this circumstance is not uniform. For example, the analysis of ownership structure with compliance levels (refer Section 5.5.2) shows that the variations in corporate governance compliance are directly related to the ownership structures of companies. Thus, it is recommended that in Sri Lanka, an analysis of the nature of corporate ownership of companies is needed, before formulating policy on corporate governance practices and regulations, in order to improve the efficiency of the corporate governance system of Sri Lanka.

The salient corporate governance features of sampled companies are summarized in Section 8.2.1.1. It is concluded that there are both positive and negative features of corporate governance practices of Sri Lankan companies, with evidence suggesting that Sri Lankan companies using positive practices align themselves with the Anglo-Saxon model. Hansmann and Kraakman (2001) state that the basic corporate form has already achieved a great deal of uniformity. They further claim that economies are approaching a world-wide consensus that managers should act in the interests of shareholders and this should include both controlling and non-controlling shareholders. Reed (2002) states that the inclination of developing countries towards the Anglo-Saxon model is associated with both historical and economic reasons. In the Sri Lankan context historical reasons refer to strong historical ties with British colonial rule and economic reasons include the

adoption of open economic policies and the influence of international funding agencies. These factors drive companies to comply with governance practices originating in Anglo-Saxon economies, despite most Sri Lankan companies having concentrated ownership.

Further, these features provide evidence of functional convergence (refer Section 2.5) of corporate governance practices by Sri Lankan listed companies. Functional convergence occurs when individual firms adapt stronger governance than mandated, despite the lack of an appropriate legal structure (Hansmann and Kraakman, 2001). Companies with foreign ownership are likely to improve their corporate governance practices unilaterally to comply with the requirements of their parent companies, resulting in functional convergence of corporate governance practices.

The negative features identified are evidence of the inadequacies in compliance with corporate governance best practice by Sri Lankan companies. These negative features are closely linked to the presence of firms' controlling shareholders, who, it is conjectured, inhibit firms' fully benefiting from the positive features of best corporate governance practices.

(3) Does the concentration of ownership with family, foreign or controlling owners impact the level of compliance with corporate governance in Sri Lankan companies?

Analysis of the questionnaire survey indicates that diffused ownership is rare in Sri Lankan companies. In most cases, the ownership of companies is concentrated in a few individuals or institutional owners. The holding of controlling ownership (ownership of over 50 per cent of issued share capital) by the largest shareholder is observed in 48 per cent of companies under review. Further, it shows that if the first ten largest owners are considered, the controlling ownership has increased to 97 per cent of the companies surveyed, suggesting the presence of controlling owners for most Sri Lankan companies. This characteristic implies that most Sri Lankan listed companies are owner-managed or owner-controlled companies. Studies conducted in Asian and Western European countries also reveal ownership concentration in most companies (La Porta et al., 1999, Faccio and Lang, 2002). As revealed in the

analysis, another salient characteristic of ownership is the wide prevalence of family ownership, as in the case of other Asian countries. Claessens et al. (2000) show that in family controlled Asian firms, the controlling shareholder often acts as a top manager of the company.

The concentrated ownership structure of Sri Lankan companies strongly influences the level of corporate governance as discussed in Sections 5.5.2 and 5.5.3. Some of the inadequacies in compliance with best practice are closely linked to the presence of the controlling shareholders, which is a common phenomenon in the Asian Region, as shown in the OECD White Paper on Corporate Governance in Asia (2003). Controlling shareholders influence: the appointment of directors; the independence of non-executive directors; the conduct of board meetings; non-controlling shareholders' participation on the board; and, performance evaluations of directors. Hence, this potentially creates problems in relation to protecting non-controlling shareholders' rights. The successful implementation of the corporate governance best practice in Sri Lankan companies therefore, depends very much on the level of influence of controlling shareholders, and their ownership patterns. Given the nature of ownership concentration of Sri Lankan companies, it is recommended that policy makers put more weight on the protection of shareholders' rights, especially non-controlling shareholders' rights in formulating corporate governance standards.

Extensive family ownership and the dominance of family members on boards are prevalent in Sri Lanka. The level of compliance as measured by the scores of the CGI and sub-indices provide prima facie evidence that family ownership has a negative influence on corporate governance practices. The negative impact is particularly strong in respect of board procedures, voluntary disclosures, audit committee procedures, and directors' remuneration procedures, suggesting family owners' dominate board procedures. Family ownership raises the question whether or not family management brings equivalent levels of professionalism organizations, as is experienced in companies of more widely held ownership and in which professional managers are employed. The impact of family ownership on the corporate governance structures would depend on the extent of involvement of family members in the company. Further, the context within which the family

members operate affects their behaviour in the governance process. The context could constitute factors such as family culture, individual competence, preference and values, and business conditions (Jain, 2006). As in many Asian nations family ownership is part of cultural inheritance in Sri Lanka. Although family ownership leads to lower levels of compliance with corporate governance best practices, family ownership is not always harmful if the best possible people are available to operate the firm. However, low compliance levels suggest that existing corporate governance practices are not compatible with the governance structure of family owned companies. The appropriateness of existing corporate governance practices is a key issue needing to be addressed by policy makers when they develop corporate governance practices for Sri Lankan companies.

In contrast to family ownership, substantial foreign ownership has been found to have a positive impact on compliance with corporate governance best practices across, all the corporate governance dimensions considered in this survey. Specifically, more effective boards of directors are observed in respect of these companies. These greater levels of compliance are likely to result from the governance structure of these companies, and the governance code development process in Sri Lanka. Foreign owners generally demand a higher quality of corporate governance due to pressures from parent companies. This is likely to produce greater compliance with best governance practices. Furthermore, because the SLCGC (2008)was developed based on the codes developed in the UK and other western countries, the companies which characterize companies operating under the Anglo-Saxon model are more likely to be compliant with the Code. As such, SFO firms are able to comply with recommended governance practices with ease. Given this behaviour, the applicability of the SLCGC (2008) for the majority of Sri Lankan companies needs to be investigated more closely.

The findings of the survey indicate that companies with foreign ownership embrace the Anglo-Saxon corporate governance framework thoroughly. The prevalence of family ownership and the presence of controlling shareholders raises the question how appropriate is the Anglo-Saxon model of corporate governance for Sri Lankan companies, as it presumes that ownership of publicly traded companies is widely held. Existing governance structures of Sri Lankan companies

that are dominated by controlling shareholders show some similarity to inside systems of relationship-based corporate governance, as is widespread in Continental European and Asian countries, where ownership concentration is a usual characteristic. This implies that a hybrid corporate governance system which has the characteristics of both the Anglo-Saxon model and inside systems of corporate governance is in operation in Sri Lanka. Sri Lanka's inclination towards the Anglo-Saxon model stems primarily from the development of Sri Lankan Company Law and governance codes based on British counterparts due to the colonial influence. But most Sri Lankan companies are more likely to be comfortable with the relationship-based system since it matches the existing ownership structure of these companies. Thus, the policy makers on corporate governance need to do more research on the suitability of the Anglo-Saxon model in formulating corporate governance standards for Sri Lankan companies. As Sri Lanka has already invested a great deal by way of establishing legal and financial systems, and an institutional framework to put the Anglo-Saxon model in place, the relationship-based model could be a complementary model rather than a substitute for existing model in Sri Lanka.

(4) Does facilitating corporate governance best practice improve corporate performance in Sri Lankan companies?

Empirical analysis reveals in improving governance practices of Sri Lankan listed companies, there is a positive impact on their financial performance as measured in terms of return on assets and return on equity. This suggests that companies are able to improve their operational and financial efficiency by securing greater levels of compliance with corporate governance practices, through the establishment of strong internal corporate governance mechanisms. There is also a growing body of evidence that corporate governance influences growth prospects of companies, which would ultimately contribute to the economic development of a country. Claessens et al. (2000) find that better corporate governance frameworks benefit firms through greater access to financing, lower costs of capital, and better performance. Furthermore, the OECD (2009) provides evidence on the key components of corporate governance, such as the role of board and board composition on improving performance of companies. The findings of

the study are consistent with these findings, which suggest that corporate governance can strengthen the operational efficiency of companies, resulting in improved performance.

Many empirical studies (Klapper and Love, 2002, Gompers et al., 2003, Black et al., 2003) find that well governed companies receive higher market valuations. However, the results of this study show a negative relationship between corporate governance and market values, possibly resulting from market anomalies prevailing in Sri Lanka. In most small markets, market prices are subject to manipulations, signalling, group behaviour, and mistakes (Kapopoulos and Lazaretou, 2007). In addition to market anomalies, variable measurement problems such as the use of the proxy Tobin's Q and the use of a relatively small sample may have resulted in estimation errors. Due to these reasons, the validity of market performance measures is debatable, especially in an emerging market where market anomalies and inefficiencies play a dominant role in deciding market prices. Further studies with a larger sample incorporating both longitudinal and cross sectional data are desirable to address these issues in the Sri Lankan context.

(5) Do the current corporate governance practices in Sri Lanka meet stakeholders' expectations?

The results of the stakeholders' perception survey found that the majority of stakeholders are not happy with the present status of corporate governance in Sri Lanka. They are of the view that it is not comparable to that of a developed country, or even an Asian country, indicating their strong dissatisfaction. On the basis of this finding, it can be concluded that the companies and regulators, including monitoring authorities, have failed to satisfy stakeholders' expectations of corporate governance standards. The majority of them agree that sound corporate governance practices have an impact on corporate financial, market and social performance, suggesting that investors are willing to pay a premium price for the shares of well governed companies. However, they are of the view that the political interventions cannot be minimized in the Sri Lankan context, even with sound corporate governance, indicating the severity of political interventions in Sri Lanka. According to their opinion, the important components of the corporate governance

system in Sri Lanka include governance codes, a financial reporting framework, a regulatory framework, and codes of conduct and ethics. However, the judiciary is not recognized as an important component, indicating stakeholders' dissatisfaction with a weak judicial enforcement prevailing in Sri Lanka. Furthermore, stakeholders are of the view that other organizations which formulize and monitor corporate governance requirements of listed companies are not executing their functions efficiently.

When the stakeholders are asked to identify issues of concern regarding corporate governance in Sri Lanka, they select: a lack of education in and awareness of corporate governance; inadequate regulations and enforcement; a lack of integrity and independence of directors; insufficient ethical standards; a lack of transparency; ownership concentration; and, political interventions, insider trading and corruption as significant corporate governance problems in Sri Lanka. Their recommendations to address these issues include the enforcement of strict regulations through regulatory monitoring; sufficient education for board members and senior management; more emphasis on judicial enforcement; increased ethical standards; and, prevention of political intervention. The findings of the survey provide a number of directions regarding aspects to be considered in developing corporate governance best practice to suit the local conditions, and the factors to be considered in improving the efficient implementation of these practices in the Sri Lankan environment. Furthermore, this survey highlights the importance of undertaking similar kinds of surveys from time to time covering all types of stakeholder groups, to get an understanding of the stakeholders' opinions on governance standards and their enforcement.

(6) Does the ownership concentration influence firm performance of Sri Lankan companies?

The effects of ownership concentration on firms' performance are considered important in the search for an appropriate governance model for an economy. One of the objectives of this study is to examine the impact of ownership concentration on the performance of public listed companies in Sri Lanka. Many studies examine the impact of ownership concentration on performance conclude that higher levels

of ownership concentration may improve performance by decreasing monitoring costs or alternatively, performance can decline if large shareholders use their control rights to achieve private benefits (Shleifer and Vishny, 1986, Morck et al., 1988, Thomsen et al., 2006, Zeitun and Tian, 2007). Further, these studies suggest that performance implications of ownership concentration are largely contextual. This study finds that ownership concentration has a positive and significant impact on financial performance of ROA and ROE. Further, it is found that the ownership structure, which is measured in terms of ownership concentration with either individuals or a corporate entity, has a significant effect on ROA. However, ownership concentration did not show any significant effect on market-based performance measures of TQ and MBR.

The results of the study can partially be explained by the arguments of agency theory. The significant impact of the OC variables on ROA and ROE support Shleifer and Vishny's (1986) hypothesis that concentrated ownership might reduce agency costs, and hence increase firm performance. The survey on corporate governance in Sri Lanka shows that ownership is concentrated with the presence of controlling shareholders in most firms. Further, controlling shareholders' participation in management was also evident from the survey results (Section 5.5.3). Thus, the results are also consistent with the claims made by Jensen and Meckling (1976); that the inside owners have incentives to pursue their own benefits relative to the amount of ownership held by them, which in turn are aligned to enhance firm performance and value. Thus, the results of this study show that ownership concentration has a positive impact on financial performance.

However, insignificant results of the concentration of variables on both TQ and MBR are not consistent with agency theory arguments. Prior studies that examine the relationship between ownership concentration and firm value have produced mixed results (Agrawal and Knoeber, 1996, Demsetz and Villalonga, 2001, Thomsen et al., 2006). The insignificant results of market performance measures may be due to the inefficiency of the Sri Lankan equity market, where company fundamentals are not impounded into share prices efficiently. The use of a proxy TQ might have aggravated the problem because accounting measurement problems are also imbedded in TQ, in addition to market inefficiencies. Both TQ and MBR

are subject to inherent market anomalies, such as insider trading and price fixing, which are common in small markets. These factors could have resulted in the insignificant relationship observed in the study.

8.4 Limitations of the Study

The questionnaire survey is used as the primary method of data collection in the study. Therefore the limitations commonly applicable to questionnaire surveys are equally applicable to this study. The scope of the study of the corporate governance survey is limited to public companies listed on the CSE. Due to practical reasons, no attempt was made to include both government sector organizations and non-listed companies. The result of the study would have been different if the sample had extended to include these sectors. This limitation may restrict the generalizability of the findings only to listed companies. The level of compliance to corporate governance practices by government owned enterprises and private owned small and medium enterprises in Sri Lanka cannot be comprehended by analysing the results of this study due to differences in applicable laws and regulations. Therefore, there is a need to increase the coverage of similar surveys to obtain a more comprehensive picture of corporate governance in Sri Lanka.

The analysis of the corporate governance survey is limited to sixty publicly listed companies, due to data collection limitations. Although the sample is small, it represents fourteen sectors out of twenty sectors of the CSE. As a result the sample is representative of companies listed on the CSE. However, the small size of the sample restricts in-depth statistical analysis such as regression analysis to find out the causal relationships between the variables. Although a 26% overall response rate is acceptable for survey research, it would have provided more comprehensive insights into the compliance of corporate governance practices in the Sri Lankan context if a higher response rate was achieved in the survey.

The CGI of the study is contracted based on the codes of best practice that have been developed in line with the Anglo-Saxon model. However, the practices developed in the Anglo-Saxon model may not fully address the requirements of Sri Lankan

companies. Therefore, benchmarking governance practices of local companies with this model may not fully reflect the exact status of their governance.

The analysis of performance implications of ownership concentration is limited to direct shareholdings of owners, without analysing ultimate ownership. However, given the nature of ownership structures in Sri Lankan companies, ultimate ownership which is acquired either directly or indirectly could have a significant impact on performance. Only direct ownership is considered in the study due to the practical limitation of accessing indirect ownership data for Sri Lankan companies. Further, the analysis of ownership structure is limited to family, foreign and controlling ownership, but there are other types of ownership structures such as institutional ownership and controlling-family ownership. Non availability of data at this level of detail has prevented in depth analysis of ownership structure of sample firms. Thus, future studies should extend the definition of ownership beyond direct shareholdings to examine the impact of ultimate ownership on firm performance. Another limitation of this study is the use of pooled data regression analysis, which assumes that the intercept and slope coefficients are constant across time and sectors.

8.5 Directions for Future Research

This study has provided some interesting insights into the three aspect of corporate governance in Sri Lanka. First, the corporate governance survey provides the nature and level of compliance with corporate governance best practices by listed companies. Secondly, the analysis of major issues and the present status of corporate governance in Sri Lanka from stakeholders' points of view is a novel exploration, as no prior research has been made to examine stakeholders' perceptions on corporate governance in Sri Lanka. Thirdly, the performance implications of ownership concentration provide in-depth analysis of the nature and implications of ownership concentration on Sri Lankan companies. Thus, the combined outcomes of these examinations provide a broader framework for future research in this area. Mentioned below are some aspects that deserve future research.

There is a properly articulated regulatory and institutional framework for corporate governance in Sri Lanka. The corporate governance requirements of Sri

Lankan listed companies have been strongly influenced by the Anglo-Saxon model of corporate governance. This is because codes of best practices, company law and other regulations have been developed in line with this model, owing to colonial influences. Although constancy in the legal, accounting and corporate governance systems is a legacy of a colonial past, and this is common to many emerging nations, findings of this study concur with previous studies in expressing concern as to the appropriateness of such systems to the local environment (Perera, 1985, Wijewardene and Yapa, 1998).This exposure raises an important issue to consider in future research, by exploring how a model originating from developed countries can be readily and effectively transposed into a developing country like Sri Lanka.

It is found that in Sri Lanka, compliance with corporate governance practices is directly influenced by ownership patterns. The salient characteristics of ownership structure are the wide prevalence of family ownership, foreign ownership and the presence of controlling shareholders in most companies. Ownership concentration to a certain extent is associated with the Asian culture. Hence, the cultural dimension justifies to a certain extent the wide prevalence of family ownership of Sri Lankan companies. The corporate governance and associated issues of Sri Lankan companies should be explored from a much broader perspective. Thus, an interdisciplinary approach covering disciplines such as strategic management, sociology and political science could be adopted in future research.

The study of the performance implications of ownership concentration is limited to industrial sector companies of the CSE excluding the bank, finance and insurance sector. This sector was excluded due to the non-comparability of applicable regulations regarding share ownership concentration, profitability measures and liquidity assessment compared to industrial sectors. Also, the sample of companies was limited to publicly listed companies in Sri Lanka. However, the banking sector and SME sector are of vital importance to the economic development of the country. Therefore an attempt could be made to cover these business sectors in the future studies.

The examination of performance implications of ownership concentration shows that it has a positive impact on financial performance. However, the level of compliance with best practices is negatively affected by the presence of controlling shareholders and

family ownership concentration. Levels of compliance, as measured in terms of scores of the CGI, have been assessed based on corporate governance best practices promoted by the codes and other governance principles originating in developed countries. These practices may not be suitable to some companies which have strong family orientation. The well performing family owned companies may have been governed by their own governance practices. These indigenous governance practices could originate from the socio-cultural context of the country. This aspect is not explored in the study and it could be an interesting research issue to explore in future studies. Hence, it is recommended to explore the fact whether Sri Lankan listed companies are adopting any indigenous governance practices, how these practices differ from the best practices recommended in the governance codes, and their impacts on the performance of companies. As it is vital to examine corporate governance practices more closely, the case study approach can be applied to carry out a comprehensive analysis of family based companies or groups of companies.

The stakeholders' opinion survey has provided vital information for policy makers, corporate governance monitoring agencies and company directors who are ultimately responsible for implementing best practices in their companies. However, no prior research had made any attempt to examine the stakeholders' perceptions of corporate governance in Sri Lanka. Therefore, this research is a stepping stone for future research in this area. This research can be extended to cover broader aspects of corporate governance with larger sample of stakeholders. Furthermore, future research can expand to cover a specific stakeholder group on a particular aspect of corporate governance to get in-depth understanding on the issue examined. For example, the study of NEDs' perception on compliance with corporate governance practices or the effectiveness of board sub committees in their respective companies. This will enable discovery of the practical nature of compliance from differing points of view.

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APPENDICES

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Appendix 1: List of Specified Business Enterprises

- Companies licensed under the Banking Act, No. 30 of 1988.
- Companies authorised under the Control of Insurance Act, No. 25 of 1962, to carry on insurance business.
- Companies carrying on leasing business.
- Factoring companies.
- Companies registered under the Finance Companies Act, No. 78 of 1988.
- Companies licensed under the Securities and Exchange Commission Act, No. 36 of 1987, to operate unit trust.
- Fund Management Companies
- Companies licensed under the Securities and Exchange Commission Act, No.36 of 1987, to carry on business as stockbrokers or stock dealers.
- Companies licensed under the Securities and Exchange Commission Act, No. 36 of 1987, to operate a Stock Exchange.
- Companies listed in a Stock Exchange licensed under the Securities and Exchange Commission Act, No.36 of 1987.
- Other Companies:
    - Which have a turnover in excess of Rupees of 500 Million.
    - Which at the end of the previous financial year, had shareholders equity in excess of Rupees 100 Million.
    - Which at the end of the previous financial year had gross assets in excess of Rupees 300 Million.
    - Which at the end of the previous year, had liabilities to banks and other financial institutions in excess of Rupees 100 Million.
    - Which have a staff in excess of 1000 employees.
    - Public Corporations engaged in the sale of goods or the provision of services.
    - A group of companies, any one of which falls within any of the above categories. For this purpose, a group of companies means a holding company and its subsidiaries, the accounts of which have to be consolidated under section 147 of the Companies Act No.17 of 1982.

Appendix 2: Main Principles of Sri Lankan Corporate Governance Codes of 2003 and 2008

Code of Best Practice - 2003		Code of Best Practice - 2008	
Ref. No.	**Main Principles**	**Ref. No.**	**Main Principles**
A	**Directors**	**A**	**Directors**
A.1	**Concept: The Board**	**A.1**	**Concept: The Board**
	Principle: Should have an effective Board and it should lead and control the company		**Principle:** Should have an effective Board and it should Direct, lead and control the company
A.1.1		A.1.1	Meet regularly and have at least one meeting per quarter
A.1.2	Board should have formal schedule of matter for decision including:	A.1.2	Board should be responsible for matters including:
	1.2.1 Review/formulate and monitor implementation of strategy.		1.2.1 Ensuring formulation and implementation of strategy.
	1.2.2 Ensure CEO and Management Team is competent.		1.2.2 Ensure CEO and Management Team is competent.
	1.2.3 Effective CEO and management succession plan.		1.2.3 Ensure effective CEO and management succession plan.
	1.2.4 Effective information, control and audit system.		1.2.4 Ensure effective information, internal control and risk mgt.
	1.2.5 Compliance with legal and ethical standards.		1.2.5 Ensure compliance with legal and ethical standards.
	1.2.6 Ensure prevention and management of risks.		1.2.6. Ensure all stakeholders' interest in corporate decisions
	1.2.7 Perform other board functions.		1.2.7 Ensure the use of company values and standards in accounting policies and financial regulations.
			1.2.8 Perform other board functions.
A.1.3	Take independent professional advice if necessary at company's expense.	A.1.3	Board collectively and directors individually must act in accordance with laws of the country. Take independent professional advice if necessary at company's expense.
A.1.4	All directors should have access to company secretary.	A.1.4	All directors should have access to company secretary.
A.1.5	All directors should bring an independent judgment.	A.1.5	All directors should bring an independent judgment.
A.1.6	Dedicate adequate time & effort.	A.1.6	Dedicate adequate time & effort.
A.1.7	Receive training on general aspects of directorship and matters specific to industry and company.	A.1.7	Receive training on general aspects of directorship and matters specific to industry and company.
A.2	**Concept: Chairman and CEO**	**A.2**	**Concept: Chairman and CEO**
	Principle: Two roles should be clearly segregated, with clear division of responsibilities.		**Principle:** Two roles should be clearly segregated, with clear division of responsibilities.

A.2.1	If two roles are combined:		If two roles are combined:
	Justification should be presented.		Justification should be presented and highlighted in the annual Report.
	Should have a strong, independent NEDs in the board with identified lead directors.		
A.3	**Concept: Chairman's Role**	**A.3**	**Concept: Chairman's Role**
	Principle: Responsible for running of board, preserve order and facilitate effective discharge of board functions		**Principle:** Responsible for running of board, preserve order and facilitate effective discharge of board functions
A.3.1	Should ensure:	A.3.1	Should ensure:
	3.1.1 Effective participation of executive director & NEDs.		3.1.1 Effective participation of executive director & NEDs.
	3.1.2 All directors effectively contribute for the benefit of the company.		3.1.2 All directors effectively contribute for the benefit of the company.
	3.1.3 Balance of power in the board.		3.1.3 Balance of power in the board.
	3.1.4 Sense or decision of directors on issues is ascertained		3.1.4 Sense or decision of directors on issues is ascertained
	3.1.5 Board is in complete control of company affairs.		3.1.5 Board is in complete control of company affairs.
A.4	**Concept: Financial Acumen**	**A.4**	**Concept: Financial Acumen**
	Principle: Board should ensure availability of financial acumen amongst its members		**Principle:** Board should ensure availability of financial acumen amongst its members
A.5	**Concept: Board Balance.**	**A.5**	**Concept: Board Balance.**
	Principle: Have a balance of executive and non-executive directors. No individual or group can dominate the board decision		**Principle**: Have a balance of executive and non-executive directors. No individual or group can dominate the board decision
A.5.1	Director to be deemed independent if the director has no material relationship with the company.	A.5.1	Should include NEDs with sufficient calibre and NEDs should be two or 1/3 whichever is higher in the board. In case of CEO duality NEDs should be the majority. Numbers should be based on last AGM.
A.5.2	Should include NEDs with sufficient calibre and in number not less than 1/3 of the board. In case of CEO duality NEDs should be the majority.	A.5.2	If only have two NEDs, they must be independent and all other cases two or 1/3 of NEDS which ever higher should be independent.
A.5.3	Majority of NEDs should be independent of management and free of any business and other relationship. They should be identified in the annual report.	A.5.3	Director is deemed independent if he is independent of Management and free of any business with the firm.
		A.5.4	Each NEDs should declare his or her independence or non-independence. (Using Schedule H Form)

		A.5.5	Board should determine annually the independence or non-independence of directors based on declaration and disclose in the annual reports. When criteria are not met but if the board decided to consider NED as independent director that fact should be disclosed in the annual reports.
		A.5.6	In case of CEO duality, Senior Independent Director should be appointed and disclose in annual reports.
		A.5.7	Senior Independent Director should be available for confidential discussion with other directors in matters concerning to business.
		A.5.8	Chairman should hold, at least once a year, meeting with NEDs without EDs.
		A.5.9	If the board con not have unanimous decision this fact should be minuted.
A.6	**Concept: Supply of Information**	**A.6**	**Concept: Supply of Information**
	Principle: Board should have access to timely information of quality required for decision making.		**Principle:** Board should have access to timely information of quality required for decision making.
A.6.1	Management has an obligation for supply of information. Directors make further inquiries if necessary.	A.6.1	Management has an obligation for supply of information. Directors make further inquiries if necessary.
		A.6.2	Minutes, agenda and paper required for a meeting be provided at least 7 days prior to meeting.
A.7	**Concept: Appointments to the Board**	**A.7**	**Concept: Appointments to the Board**
	Principle: Should have a formal and transparent procedure for the appointment of new directors.		**Principle:** Should have a formal and transparent procedure for the appointment of new directors.
A.7.1	Nomination committee should be established to make recommendations for all new board appointments. Terms set out in Schedule A	A.7.1	Nomination committee should be established to make recommendations for all new board appointments. Terms set out in Schedule A
	Chairman of nomination committee should be a NED and majority of members should also be NEDs.		
A.7.2	Either nomination committee or board assesses board-composition in terms of knowledge and experience of the board and whether it matches the company requirements on annual basis.	A.7.2	Either nomination committee or board assesses board-composition in terms of knowledge and experience of the board and whether it matches the company requirements on annual basis.

A.7.3	Upon new appointment to board, the company should disclose to shareholders, about such directors: a brief resume, expertise, other directorship.	A.7.3	Upon new appointment to board, the company should disclose to shareholders, about such directors: a brief resume, expertise, other directorship, whether the director can be considered independent.
A.8	**Concept: Re-election**	**A.8**	**Concept: Re-election**
	Principle: all directors should pose themselves for re-election at regular intervals and at least once every three years.		**Principle:** all directors should pose themselves for re-election at regular intervals and at least once every three years.
A.8.1	NEDs should be appointed for a specified term and re-appointment should not be automatic.	A.8.1	NEDs should be appointed for a specified term and re-appointment should not be automatic.
A.8.2	Chairman and all directors should be subject to election by shareholders and hold offices for a period not more than 3 years and re-elected.	A.8.2	Chairman and all directors should be subject to election by shareholders and hold offices for a period not more than 3 years and re-elected.
A.9	**Concept: Appraisal of Board Performance**	**A.9**	**Concept: Appraisal of Board Performance**
	Principle: Boards should periodically evaluate own performance.		**Principle:** Boards should periodically evaluate own performance.
A.9.1	In annual self-appraisal process board should evaluate its key responsibilities focusing on;	A.9.1	In annual self-appraisal process board should evaluate its performance in discharging responsibilities as set out in A.1.2 (Schedule B- Board Performance Evaluation Checklist)
	9.1.1 Reviewing/formulating and monitoring of sound business strategy.	A.9.2	Board should evaluate the performance of its committees.
	9.1.2 Ensure that CEO and management team are competent and succession plans are developed.	A.9.3	How such performance evaluation is conducted should be disclosed in the annual report.
	9.1.3 Prevalence of effective systems on information, control and audit.		
	9.1.4 Ensure compliance with legal & ethical standards, and prevention/management of risks. (Schedule B- Board Performance Evaluation Checklist)		
		A.10	**Concept: Disclosure of information in respect of Directors**
			Principle: Shareholders should be kept informed about the details of directors.
		A.10.1	Main information about directors such as brief profile, expertise, immediate family and material business relationship with other director of the company, other directorship in listed companies, attendance to meetings, committee membership etc. should be disclosed in the Annual report.

A.10	**Concept: Appraisal of CEO**	A.11	**Concept: Appraisal of CEO**
	Principle: Assess CEO performance at least on annual basis.		**Principle:** Assess CEO performance at least on annual basis.
A.10.1	At the beginning of each financial year CEO should be given targets, which are set by board and CEO together, to be met in line with corporate objectives.	A.11.1	At the beginning of each financial year CEO should be given targets, which are set by board and CEO together, to be met in line with corporate objectives.
A.10.2	Undertake appraisal of CEO's performance at the year-end.	A.11.2	Undertake appraisal of CEO's performance at the year-end.
B	**Directors' Remuneration**	**B**	**Directors' Remuneration**
B.1	**Concept: Remuneration Procedure**	**B.1**	**Concept: Remuneration Procedure**
	Principle: formal, transparent procedure for setting director remuneration should be in force. No director involve with deciding his or her own remuneration.		**Principle:** formal, transparent procedure for setting director remuneration should be in force. No director involve with deciding his or her own remuneration.
B.1.1	Set-up remuneration committees comprised of NEDs in reference to company specific terms of reference on executive remuneration packages.	B.1.1	Set-up remuneration committees comprised of NEDs in reference to company specific terms of reference on executive remuneration packages.
B.1.2	Remuneration committees comprise only of independent NEDs.	B.1.2	Remuneration committees comprise only of independent NEDs.
B.1.3	Members of remuneration committees should be disclosed annually to shareholders of the company.	B.1.3	Members of remuneration committees should be disclosed annually to shareholders of the company.
B.1.4	NED remuneration should be determined either by shareholders if permitted by articles of association, or by board as a whole. If articles permitted by a small sub-committee.	B.1.4	NED remuneration should be determined either by shareholders if permitted by articles of association, or by board as a whole. If articles permitted by a small sub-committee.
B.1.5	Remuneration committee should consult the chairman and/or CEO on proposals relating to remuneration of other directors, and have access to professional advice(s) of outside the company.	B.1.5	Remuneration committee should consult the chairman and/or CEO on proposals relating to remuneration of other directors, and have access to professional advice(s) of outside the company.
B.2	**Concept: The Level and Make-up of Remuneration**	**B.2**	**Concept: The Level and Make-up of Remuneration**
	Principle: Level and makeup of Director remuneration should be at a level sufficient to attract & retain directors needed for success of the company.		**Principle:** Level and makeup of Director remuneration should be at a level sufficient to attract & retain directors needed for success of the company.
	In respect of above matter remuneration committees should,		In respect of above matter remuneration committees should,

B.2.1	Provide packages needed to attract directors of right quality and to avoid excess pay.	B.2.1	Provide packages needed to attract directors of right quality and to avoid excess pay.
B.2.2	Judge where to position the company in relative to other companies.	B.2.2	Judge where to position the company in relative to other companies.
B.2.3	Be sensitive to pay and employment conditions elsewhere in the group.	B.2.3	Be sensitive to pay and employment conditions elsewhere in the group.
B.2.4	Performance related elements in the executive director remuneration are aligned with interests of shareholders.	B.2.4	Performance related elements in the executive director remuneration are aligned with interests of shareholders.
B.2.5	Executive share options should not be offered at a discount i.e. less than prevailing market price.	B.2.5	Executive share options should not be offered at a discount i.e. less than prevailing market price.
B.2.6	Follow requirements in schedule D of CGBP in relation to designing schemes of performance related remuneration.	B.2.6	Follow requirements in schedule D of CGBP in relation to designing schemes of performance related remuneration.
B.2.7	Set notice periods of one year or less not to disrupt the business operations.	B.2.7	Should consider what compensation commitments would entail in the event of early termination.
B.2.8	Should consider what compensation commitments would entail in the event of early termination.	B.2.8	Avoid rewarding poor performance and reduce remuneration of departing directors' to reflect their obligation to compensate the loss.
B.2.9	Avoid rewarding poor performance and reduce remuneration of departing directors' to reflect their obligation to compensate the loss.	B.2.9	Level of remuneration of NEDs should reflect the time and responsibilities of their job.
B.3	**Concept: Disclosure of Remuneration**	**B.3**	**Concept: Disclosure of Remuneration**
	Principle: Disclose in annual report of remuneration policy and details of remuneration of the board as a whole.		**Principle:** Disclose in annual report of remuneration policy and details of remuneration of the board as a whole.
B.3.1	Total remuneration of the executive and NEDs should be disclosed separately, but not of individual directors.	B.3.1	Total remuneration of the executive and NEDs should be disclosed separately, but not of individual directors.
C	**Relationship with Shareholders**	**C**	**Relationship with Shareholders**
C.1	**Concept: Constructive use of the AGM**	**C.1**	**Concept: Constructive use of the AGM**
	Principle: Board use AGM to communicate with investors and encourage their participation.		**Principle:** Board use AGM to communicate with investors and encourage their participation.
C.1.1	All proxy votes should be counted except when polls called and should indicate the votes for and against the resolution.	C.1.1	All proxy votes should be counted except when polls called and should indicate the votes for and against the resolution.
C.1.2	Separate resolutions should be in-force for substantial issues and adoption of accounts.	C.1.2	Separate resolutions should be in-force for substantial issues and adoption of accounts.

C.1.3	Chairman of the board should facilitate that Chairpersons of audit, remuneration and nomination committees are available at AGM to respond questions.	C.1.3	Chairman of the board should facilitate that Chairpersons of audit, remuneration and nomination committees are available at AGM to respond questions.
C.1.4	Should arrange notice annual report to reach shareholders before 21 days prior to scheduled date.	C.1.4	Should arrange notice annual report to reach shareholders as determined by statute, prior to scheduled date.
C.1.5	Should circulate with notice of AGM summary of procedures on voting at AGM.	C.1.5	Should circulate with notice of AGM summary of procedures on voting at AGM.
C.2	**Concept: Major Transactions**	**C.2**	**Concept: Major Transactions**
	Principle: Disclose to Shareholders, all proposed corporate transactions which would materially alter company's net assets.		**Principle:** Disclose to Shareholders, all proposed corporate transactions which would materially alter company's net assets.
C.2.1	Directors should disclose all material facts of all transactions which would materially affect net assets of the company.		Directors should disclose all material facts of all transactions which would materially affect net assets of the company.
D	**Accountability and Audit**	**D**	**Accountability and Audit**
D.1	**Concept: Financial Reporting**	**D.1**	**Concept: Financial Reporting**
	Principle: Board should present a balanced and understandable assessment of the company's position and prospects.		**Principle:** Board should present a balanced and understandable assessment of the company's position and prospects.
D.1.1	Board is responsible for submission of interim and price sensitive public reports,and information required by statutes.	D.1.1	Board is responsible for submission of interim and price sensitive public reports and information required by statutes.
D.1.2	Annual report contains declaration by the board covering aspects:	D.1.2	Annual report contains declaration by the board covering aspects:
	Company has not engaged in unlawful and activities against regulations.		Company has not engaged in unlawful and activities against regulations.
	Directors have declared all their material interests in contracts.		Directors have declared all their material interests in contracts.
	Company has ensured equitable treatment to shareholders.		Company has ensured equitable treatment to shareholders.
	Business is going concern.		Business is going concern.
	Have conducted a review of internal controls.		Have conducted a review of internal controls.
D.1.3	Annual report should contain a statement on responsibilities of the board together with a statement from Auditors about their responsibilities.	D.1.3	Annual report should contain a statement on responsibilities of the board together with a statement from Auditors about their responsibilities.
D.1.4	Annual report should contain a Management Report.	D.1.4	Annual report should contain a Management Report.
D.1.5	Directors should report that business is 'Going Concern'.	D.1.5	Directors should report that business is 'Going Concern'.

D.1.6	In the event the net assets of the company falls below one half of shareholder funds an extra-ordinary meeting should be called and notify shareholders of the position and remedial actions.	D.1.6	In the event the net assets of the company falls below one half of shareholder funds an extra-ordinary meeting should be called and notify shareholders of the position and remedial actions.
D.2	**Concept: Internal Control**	**D.2**	**Concept: Internal Control**
	Principle: Board should maintain sound internal control system to safeguard "SHs, investments, and Assets.		**Principle**: Board should maintain sound internal control system to safeguard "SHs, investments, and Assets.
D.2.1	Board should conduct annual review of system of internal control and report to shareholders.	D.2.1	Board should conduct annual review of system of internal control and report to shareholders.
D.2.2	In the event an internal audit is not available, consider periodically need for one.	D.2.2	In the event an internal audit is not available, consider periodically need for one.
D.3	**Concept: Audit Committee & Auditors**	**D.3**	**Concept: Audit Committee (AC)**
	Principle: Establish formal and transparent arrangements to consider application of financial reporting and internal control principles and to maintain appropriate relationship with company auditors.		**Principle:** Establish formal and transparent arrangements to consider application of financial reporting and internal control principles and to maintain appropriate relationship with company auditors.
D.3.1	Establish audit committee of at least three NEDs; majority of them should be independent, with clear terms of reference.	D.3.1	Establish audit committee of at least two independent NEDs or exclusively NEDs majority of them should be independent.
D.3.2	Audit committee should review the scope, results of the audit, independence and objectivity of the auditors.	D.3.2	Audit committee should review the scope, results of the audit, independence and objectivity of the auditors.
		D.3.3	Audit committee should have written terms of reference. This should include purpose and duties and responsibilities of Audit committee. **Purpose:** Assist Board over sighting matters such as: Accounting and Financial Statements, Compliance with regulations, Internal control, Going Concern assessment and external auditors' independence and performance. Responsibilities are included in code of best practices of audit committee (2002).
		D.3.4	Disclosures in AR includes: Name of AC members, Basis for determination of Auditors independence;
		D.4	**Concept: Code of Business Conduct and Ethics**
			Principle: Companies must adopt a code of Business conduct and ethics for directors and Senior management team and disclose any waivers.

		D.4.1	Companies must disclose whether they have such code and compliance with this code by its directors and senior management. If they are unable do such declaration that fact must disclose with reasons.
		D.4.2	Chairman must disclose in the annual report that he is not aware of any violation of code of ethics.
D.4	**Concept: Corporate Governance**	**D.5**	**Concept: Corporate Governance Disclosures**
	Principle: Directors should disclose the extent to which company adheres to principles/practices of corporate governance best practices.		**Principle:** Directors should disclose the extent to which company adheres to principles/practices of corporate governance best practices.
D.4.1	CG report should be included into Annual Report.	D.5.1	CG report should be included into Annual Report.
E	**Institutional Investors.**	**E**	**Institutional Investors.**
E.1	**Concept: Shareholders Voting**	**E.1**	**Concept: Shareholders Voting**
	Principle: Institutional investors should use their votes and take steps that their voting rights are translated into practice.		**Principle:** Institutional investors should use their votes and take steps that their voting rights are translated into practice.
		E.1.1	Should conduct a regular and structured dialogue with shareholders.
E.2	**Concept: Evaluation of Governance Disclosures**	**E.2**	**Concept: Evaluation of Governance Disclosures**
	Principle: Institutional investors give due weight in evaluating governance arrangements particularly board structure and all relevant factors drawn to their attention.		**Principle:** Institutional investors give due weight in evaluating governance arrangements particularly board structure and all relevant factors drawn to their attention.
F	**Other Investors**	**F**	**Other Investors**
F.1	**Concept: Investing and de-investing decisions**	**F.1**	**Concept: Investing and de-investing decisions**
	Principle: In investing and divesting decisions, individual investors should seek expert advice.		**Principle:** In investing and divesting decisions, individual investors should seek expert advice.
F.2	**Concept: Shareholder Voting**	**F.2**	**Concept: Shareholder Voting**
	Principle: Individual investors should participate in AGMs and exercise voting rights.		**Principle:** Individual investors should participate in AGMs and exercise voting rights.

Appendix 3: Listing Rules 2009: Section 7.10 Corporate Governance

Compliance

a. A Listed Entity shall publish in the annual report relating to the financial year commencing on or after 01st April 2007 a statement confirming that as at the date of the annual report they are in compliance with the Corporate Governance Rules and if they are unable to confirm compliance, set out the reasons for its inability to comply.

b. A Listed Entity shall comply with these Corporate Governance Rules with effect from the financial year commencing on or after 01st April 2008 and the annual report must contain the relevant affirmative statements.

c. Where a Listed Entity is required by any law applicable to such Listed Entity to comply with rules on Corporate Governance promulgated under such law, the board of directors of the Exchange may exempt such Listed Entity from the requirement to comply with these Corporate Governance Rules either in full or in part. Such Listed Entity shall make disclosures of compliance with Corporate Governance Rules applicable to that sector and the annual report must contain the relevant affirmative statements.

7.10.1 NON – EXECUTIVE DIRECTORS

a. The board of directors of a Listed Entity shall include at least, - two non-executive directors; or - such number of non-executive directors equivalent to one third of the total number of directors whichever is higher.

b. The total number of directors is to be calculated based on the number as at the conclusion of the immediately preceding Annual General Meeting.

c. Any change occurring to this ratio shall be rectified within ninety (90) days from the date of the change.

7.10.2 INDEPENDENT DIRECTORS

a. Where the constitution of the board of directors includes only two non-executive directors in terms of Rule 7.10.1.a above, both such non-executive directors shall be 'independent'. In all other instances two or 1/3 of non-executive directors appointed to the board of directors, whichever is higher shall be 'independent'.

b. The board shall require each non-executive director to submit a signed and dated declaration annually of his/her independence or non-independence against the specified criteria. A specimen of the said declaration is given in Appendix 7A of this Section.

7.10.3 DISCLOSURES RELATING TO DIRECTORS

a. The board shall make a determination annually as to the independence or non-independence of each non-executive director based on such declaration and other information available to the board and shall set out in the annual report the names of directors determined to be 'independent'.

b. In the event a director does not qualify as 'independent' against any of the criteria set out below but if the board, taking account all the circumstances, is of the opinion that

the director is nevertheless 'independent', the board shall specify the criteria not met and the basis for its determination in the annual report.

c. In addition to disclosures relating to the independence of a director set out above, the board shall publish in its annual report a brief resume of each director on its board which includes information on the nature of his/her expertise in relevant functional areas.

d. Upon appointment of a new director to its board, the Entity shall forthwith provide to the Exchange a brief resume of such director for dissemination to the public. Such resume shall include information on the matters itemized in paragraphs (a), (b) and (c) above.

7.10.4 CRITERIA FOR DEFINING 'INDEPENDENCE'

Subject to Rule 7.10.3 (a) and (b), a non-executive director shall not be considered independent if he/she:

a. has been employed by the Listed Entity during the period of two years immediately preceding appointment as director;

b. currently has/had during the period of two (2) years immediately preceding appointment as a director, a Material Business Relationship with the Listed Entity, whether directly or indirectly;

c. has a Close Family Member who is a director, Chief Executive Officer (and/or an equivalent position) in the Listed Entity;

d. has a Significant Shareholding in the Listed Entity;

e. has served on the board of the Listed Entity continuously for a period exceeding nine (9) years from the date of the first appointment; provided however, if such director is re-appointed after a period of two (2) years from the date of completion of the preceding nine (9) year period, he will be considered as 'independent' for the purposes of this Section.

f. is employed in another company or business,
 (i) in which a majority of the other directors of the Listed Entity are employed or are directors; or
 (ii) in which a majority of the other directors of the Listed Entity have a Significant Shareholding or Material Business Relationship; or
 (iii) that has a Significant Shareholding in the Listed Entity or with which the Listed Entity has a Business Connection;

g. Is a director of another company,
 (i) in which a majority of the other directors of the Listed Entity are employed or are directors; or
 (ii) that has a Business Connection in the Listed Entity or a Significant Shareholding;

h. Has a Material Business Relationship or a Significant Shareholding in another company or business,

(i) in which a majority of the other directors of the Listed Entity are employed or are directors; and/or

(ii) which has a Business Connection with the Listed Entity or Significant Shareholding in the same.

For the purposes of Rule 7.10.4;

- Close Family Member shall mean and include the director's spouse, parents, grandparents, children, brothers, sisters, grandchildren and any person who is financially dependent on such director.

  'Financially dependent' individuals include any person who received more than half of their support for the most recent fiscal year from a director and/or his or her spouse.

- Listed Entity shall mean the listed Entity to the board of which the director is appointed, its parent and/or subsidiary company, and a subsidiary of the parent company.

- Material Business Relationship shall mean a relationship resulting in income/non-cash benefits equivalent to 20% of the director's annual income.

- Business Connection shall mean a relationship resulting in transaction value equivalent to 10% of the turnover of that company or business.

- Significant Shareholding shall mean a shareholding carrying not less than 10% of the voting rights of a company.

7.10.5 REMUNERATION COMMITTEE

A Listed Entity shall have a remuneration committee in conformity with the following:

a. COMPOSITION

The remuneration committee shall comprise;

of a minimum of two independent non-executive directors (in instances where an Entity has only two directors on its Board);

or

of non-executive directors a majority of whom shall be independent, whichever shall be higher.

In a situation where both the parent company and the subsidiary are 'listed Entities', the remuneration committee of the parent company may be permitted to function as the remuneration committee of the subsidiary.

However, if the parent company is not a Listed Entity, then the remuneration committee of the parent company is not permitted to act as the remuneration committee of the subsidiary. The subsidiary shall have a separate remuneration committee.

One non-executive director shall be appointed as Chairman of the committee by the board of directors.

b. FUNCTIONS

The Remuneration Committee shall recommend the remuneration payable to the executive directors and Chief Executive Officer of the Listed Entity and/or equivalent position thereof, to the board of the Listed Entity which will make the final determination upon consideration of such recommendations.

c. DISCLOSURE IN THE ANNUAL REPORT

The annual report should set out the names of directors (or persons in the parent company's committee in the case of a group company) comprising the remuneration committee, contain a statement of the remuneration policy and set out the aggregate remuneration paid to executive and non-executive directors.

The Term "remuneration" shall make reference to cash and all noncash benefits whatsoever received in consideration of employment with the Listed Entity. (excluding statutory entitlements such as Employees Provident Fund and Employees Trust Fund).

7.10.6 AUDIT COMMITTEE

A Listed Entity shall have an audit committee in conformity with the following:

a. COMPOSITION

The audit committee shall comprise;

of a minimum of two independent non-executive directors (in instances where a Entity has only two directors on its board);

or

of non-executive directors a majority of whom shall be independent, whichever shall be higher.

In a situation where both the parent company and the subsidiary are 'listed Entities', the audit committee of the parent company may function as the audit committee of the subsidiary.

However, if the parent company is not a Listed Entity, then the audit committee of the parent company is not permitted to act as the audit committee of the subsidiary. The subsidiary should have a separate audit committee.

One non-executive director shall be appointed as Chairman of the committee by the board of directors.

Unless otherwise determined by the audit committee, the Chief Executive Officer and the Chief Financial Officer of the Listed Entity shall attend audit committee meetings.

The Chairman or one member of the committee should be a Member of a recognized professional accounting body.

b. FUNCTIONS

Shall include,

(i) Overseeing of the preparation, presentation and adequacy of disclosures in the financial statements of a Listed Entity, in accordance with Sri Lanka Accounting Standards.

(ii) Overseeing of the Entity's compliance with financial reporting requirements, information requirements of the Companies Act and other relevant financial reporting related regulations and requirements.

(iii) Overseeing the processes to ensure that the Entity's internal controls and risk management, are adequate, to meet the requirements of the Sri Lanka Auditing Standards.

(iv) Assessment of the independence and performance of the Entity's external auditors.

(v) To make recommendations to the board pertaining to appointment, re-appointment and removal of external auditors and to approve the remuneration and terms of engagement of the external auditors.

c. DISCLOSURE IN THE ANNUAL REPORT

The names of the directors (or persons in the parent company's committee in the case of a group company) comprising the audit committee should be disclosed in the annual report.

The committee shall make a determination of the independence of the auditors and shall disclose the basis for such determination in the annual report.

The annual report shall contain a report by the audit committee, setting out the manner of compliance by the Entity in relation to the above, during the period to which the annual report relates.

Appendix 4: Survey Questionnaire and Cover Letter

University of Wollongong

School of Accounting & Finance
University of Wollongong
Wollongong NSW 2522 Australia
Telephone +61 2 4221 3718

26 December 2009

Chairman/CEO/Director,

Dear Sir/Madam,

Survey on Corporate Governance Practices of listed companies in Sri Lanka

I am a doctoral candidate in the School of Accounting and Finance at the University ofWollongong, Australia. My doctoral study includes a research project on corporate governance practices of Sri Lankan listed companies. The major purpose of this research is to assess the effectiveness of the existing corporate governance practices in achieving better performance by Sri Lankan companies.

I invite your participation in this research by completing the attached questionnaire which will take approximately 15-20 minutes. Your co-operation in this regard is greatly appreciated. The results of the survey will be used only in an aggregated form and therefore the confidentiality of your responses is assured. This research is subject to review by the Human Research Ethics Committee of the University of Wollongong. Please refer 'Participation Information Sheet' for further information.

Please send the completed questionnaire using the self addressed envelope enclosed by 15th January 2010. We look forward to receiving your completed questionnaire and if you have any query regarding the research or questionnaire, please contact me on 0779371170 or e-mail athula@uow.edu.au. The supervisors of the project can be contacted on their email: Dr. Kathy Rudkin, krudkin@uow.edu.au and Dr. Anura Zoysa, anura@uow.edu.au.

Thank you for your co-operation.

Yours faithfully,

Athula Manawaduge
B.Sc(Mgt.), M.A.(Acc. &Fin.), ACA
Doctoral Candidate
University of Wollongong

Survey on Corporate Governance Practices of listed companies in Sri Lanka

1) Please complete the questionnaire by the CEO /a director / a suitable representative on their behalf.(Please refer question 1)

2) Please focus only on the company to which you are attached in providing your responses. Do not focus on other companies in the group.

Part – I: General Information

Please tick (√) the appropriate cage for the given statements

1. Indicate your position in the firm.

Chairman	CEO	Executive Director	Non-Executive Director	Company Secretary	Senior Manager	Other

2. Gender
   - ☐ Male
   - ☐ Female

3. Indicate your major background (You may choose more than one if applicable)
   - ☐ Business executive
   - ☐ Accounting or Financial professional
   - ☐ Lawyer
   - ☐ Other professional
   - ☐ Other: ____

4. Indicate whether your firm is a
   - ☐ Single (stand-alone) company
   - ☐ Subsidiary of a family-based business group
   - ☐ Subsidiary of a business group not controlled by families
   - ☐ Holding company of a family-based business group
   - ☐ Holding company not controlled by families

5. Select the statement that best describes the foreign investment in your firm:
   - ☐ There is no foreign investment
   - ☐ There is little ownership by foreign investors
   - ☐ There is substantial ownership by foreign investors
   - ☐ Subsidiary of a foreign firm
   - ☐ Other:____

6. Who has the greatest influence over the policies of your firm?
   - ☐ The largest shareholder the firm
   - ☐ Several bulk-shareholders collectively
   - ☐ No particular shareholder or group since there is no dominant shareholder(s)
   - ☐ Other:____

7. Does your firm have a labour union(s)? Yes ☐ No ☐

Part –II: The Board: Structure and practices

8. The board has a director representing: **Yes** **No**

(i) Institutional investor(s) ☐ ☐
(ii) Minority shareholders ☐ ☐
(iii) Controlling shareholder's family ☐ ☐

9. The board of the firm comprises:

(i) Independent directors Yes ☐ (how many : …….) No ☐
(ii) Foreign nationals Yes ☐ (how many : ....) No ☐
(iii) A Chairman distinct from the CEO Yes ☐ No ☐
(iv) If the answer to (iii) above is No;
Has the board appointed a Senior Independent director? Yes ☐ No ☐

10. Board structure and practices **Yes** **No**

(i) Does the board have bylaws to govern board meetings ☐ ☐
(ii) Does the board have a schedule of matters reserved for its consideration and approval? ☐ ☐
(iii) Are dissents recorded in the board minutes? ☐ ☐
(iv) Does your board have professional(s) in Accounting and Finance? ☐ ☐
(v) Do the non-executive directors meet without executive directors to discuss firm affairs? ☐ ☐
(vi) Does the board periodically evaluate its performance as a whole? ☐ ☐
(vii) Is the performance of the directors individually assessed each year? ☐ ☐

11. Who has the strongest voice in the selection of non-executive directors?

☐ Board or its nomination committee (autonomously)
☐ CEO
☐ Controlling shareholder(s) (who is not the CEO)
☐ Other: ____

12. How many board meetings were held last financial year?

☐ Less than 4
☐ 4 – 6
☐ 6 – 10
☐ More than 10

13 On average, how many hours did a board meeting last?

☐ Not more than 1 hour
☐ 1-2 hours
☐ 2-3 hours
☐ Over 3 hours

14. On average, what was the attendance rate for the board meetings?

☐ 90 - 100%
☐ 75 - 89%
☐ 60 - 74%
☐ 50 - 59%

15. Does your board have the following committees? **Yes** **No**

(i) Audit Committee ☐ ☐
(ii) Remuneration Committee ☐ ☐
(iii) Nomination Committee ☐ ☐

16. If the board has these committees, how many meetings were held last financial year?

	1	2 – 3	4 – 6	over 7	Unsure
(i) Audit Committee	☐	☐	☐	☐	☐
(ii) Remuneration Committee	☐	☐	☐	☐	☐
(iii) Nomination Committee	☐	☐	☐	☐	☐

17. Please give your responses to the following if your board has an Audit Committee.

	Yes	No
(i) Is there a written terms of reference specifying role and responsibilities of the committee?	☐	☐
(ii) Does the committee have someone with accounting expertise?	☐	☐
(iii) Is it comprised exclusively of non-executive directors?	☐	☐
(iv) Does the committee have a majority of independent director	☐	☐
(v) Is it chaired by an independent director?	☐	☐
(vi) Are committee minutes circulated among all the members of the board?	☐	☐
(vii) Does the audit committee recommend the external auditor to the full board?	☐	☐
(viii) Can minority shareholders elect an audit committee member?	☐	☐
(ix) Did the audit committee hold meetings with the external auditor in the last financial year?	☐	☐
(x) Are the audit committee members paid a fee or allowance for serving on the audit committee?	☐	☐

18. Please give your responses to the following if your board hasa Remuneration Committee

	Yes	No
(i) Are there written guidelines specifying role and responsibilities of the remuneration committee?	☐	☐
(ii) Is the committee comprised entirely or a majority of independent directors?	☐	☐
(iii) Is the committee chaired by an independent director?	☐	☐
(iv) Are committee minutes circulated among all the members of the board?	☐	☐
(v) Are dissents recorded in the committee minutes?	☐	☐

19. Please give your responses to the following if your board has a Nomination Committee

	Yes	No
(i) Are there written guidelines specifying role and responsibilities of the remuneration committee?	☐	☐
(ii) Does the committee comprise exclusively of non-executive directors?	☐	☐
(iii) Is the committee chaired by an independent director?	☐	☐
(iv) Are committee minutes circulated among all the members of the board?	☐	☐
(v) Are dissents recorded in the committee minutes?	☐	☐

20. Appointment of directors	Yes	No
(i) Are all appointments to the board made only through the nomination committee?	☐	☐
(ii) Does your firm have formal and transparent procedures for the election of directors?	☐	☐
(iii) Are directors subject to re-election at least once in three years?	☐	☐
(iv) Are directors subject to a limit on the number of simultaneous directorships served in other firms?	☐	☐

21. Directors' Remuneration	Yes	No
(i) Does your company have a written procedure and/or policies on directors' remuneration?	☐	☐
(ii) Does the non-executive directors' remuneration include share options?	☐	☐
(iii) Is the CEO given share options?	☐	☐
(iv) Does the board review CEO compensation annually?	☐	☐
(v) Is any component of the executive directors' remuneration performance-based?	☐	☐

(vi) Does any performance based remuneration component require shareholders' approval? ☐ ☐

22. Executive Directors and their performance **Yes** **No**

(i) Does the board formally evaluate the CEO's performance annually? ☐ ☐
(ii) Does the board formally evaluate the executive directors' performance annually? ☐ ☐
(iii) Is there a succession plan for the CEO and the senior managers? ☐ ☐
(iv) Has the board replaced the CEO during last 5 years? ☐ ☐

23. Non-Executive Directors (NEDs) and their performance **Yes** **No**

(i) Does the board formally evaluate the performance of NEDs annually? ☐ ☐
(ii) Is there a retirement age for NEDs? ☐ ☐
(iii) Do NEDs receive retirement pay? ☐ ☐
(iv) Did a NED(s) resign due to a policy disagreement during last 3 years? ☐ ☐
(v) Did the chairman hold separate meetings for non-executive directors during the last year? ☐ ☐
(vi) Can NED(s) obtain professional advice at the company expense? ☐ ☐

24. Code of conduct and other assistance **Yes** **No**

(i) Does your firm have a written code of conduct & ethics for directors? ☐ ☐
(ii) Are there written guidelines in respect of directors' share dealings of the firm? ☐ ☐
(iii) Do board members receive materials at least seven days in advance of the board meeting? ☐ ☐
(iv) Does the firm provide any training opportunities for newly appointed directors? ☐ ☐

Part –III: Stakeholders' Rights

25. Shareholders voting and other involvements **Yes** **No**

(i) Is voting by mail allowed? ☐ ☐
(ii) Can anybody serve as a proxy? ☐ ☐
(iii) Was there a shareholders request for an extraordinary meeting in last 3 years? ☐ ☐
(iv) Are candidates for directorships disclosed to shareholders prior to the AGM? ☐ ☐
(v) Are chairpersons of board sub-committees always available at the AGM? ☐ ☐
(vi) Are shareholders given adequate time for asking questions at the AGM? ☐ ☐
(vii) Are shareholders' priority subscription rights in the issuance of shares adequately protected? ☐ ☐
(viii) Are related-party transactions fully disclosed and discussed at the AGM? ☐ ☐
(ix) Is there any deviation from the one-share one-vote rule in your firm? ☐ ☐

26. External Auditor **Yes** **No**

(i) Does the audit committee conduct a formal review of the auditor's work? ☐ ☐
(ii) Does the external audit partner rotate every 5 years? ☐ ☐
(iii) Are audit recommendations subject to full board review? ☐ ☐
(iv) Does the external auditor provide non-audit services also to your firm? ☐ ☐

27. What is the non-audit fee as a percentage of total fees of the last financial year?

☐ Not applicable
☐ Less than 20%
☐ Between 21% and 50%
☐ 51% or over

28. How long did the previous year AGM last?

☐ Less than 1 hour
☐ 1-2 hours
☐ 2-3 hours
☐ Over 3 hours

29. What was the approximate percentage of voting rights exercised by the shareholders at the last year AGM?
☐ Less than 10%
☐ 10%- 40%
☐ 40%-60%
☐ 60%-80%
☐ 80%-100%

30. Does your firm disclose the following on the firm's web page?

		Yes	No
(i)	Quarterly financial statements	☐	☐
(ii)	Audited Annual reports	☐	☐
(iii)	Directors report	☐	☐
(iv)	Directors' selling or buying shares in the firm (if any)	☐	☐

31. Does your firm disclose the following information? If yes, please indicate whether they are disclosed in the Annual Report (**AR)** and/or the firm's Web Page (**Web).**

		Yes		No
		AR	**Web**	
(i)	Related-party transactions (if any)	☐	☐	☐
(ii)	Resume or background of directors	☐	☐	☐
(iii)	Individual remuneration of directors	☐	☐	☐
(iv)	Policies on risk management	☐	☐	☐
(v)	Corporate governance report	☐	☐	☐
(vi)	Separate disclosure of audit and non-audit fees paid (if any)	☐	☐	☐
(vii)	Members of board sub committees	☐	☐	☐
(viii)	Audit committee report	☐	☐	☐
(ix)	Remuneration committee report	☐	☐	☐
(x)	Nomination committee report	☐	☐	☐

Part –IV: Related Party Transactions (RPTs)

Related party transactions (RPTs) include all business transaction between the firm and related parties such as directors of the firm, principle owners, management and their immediate families, the affiliated companies etc.

32. Related Party Transactions (RPTs)

		Yes	No
(i)	Does the firm disclose RPT(s) to shareholders?	☐	☐
(ii)	Does the firm require RPT(s) to be at arms-length terms?	☐	☐
(iii)	Does the firm have any outstanding loan(s) to insider(s)?	☐	☐
(iv)	Does the firm make any sale to or purchase from insiders?	☐	☐
(v)	Does the firm rent or lease real property to or from insider(s)?	☐	☐
(vi)	Did the board review the RPT(s) last year?	☐	☐

33. What is the approximate percentage value of RPT(s) relative to the revenue in the last financial year?

☐ Not applicable
☐ Less than 1% of total revenues of the firm
☐ 1% to 5% of total revenues of the firm
☐ 5% to 10% of total revenues of the firm
☐ More than 10% of total revenues of the firm

34. What is the level of approval required to exercise a RPT(s) with executives in your firm?
☐ No approval required
☐ Approval by the CEO
☐ Approval by the board
☐ Approval by the non-conflicted directors or audit committee
☐ Approval by the shareholders
☐ Other (Please Specify):
____

35. What is the level of approval required to exercise a RPT(s) with controlling shareholder(s) in your firm?
☐ No approval required
☐ Approval by the CEO
☐ Approval by the board
☐ Approval by the non-conflicted directors or audit committee or shareholders
☐ Other (Please Specify):
____

Name of the company (Optional)

THANK YOU FOR COMPLETING THE QUESTIONNAIRE

Appendix 5: Participation Information Sheet

University of Wollongong

PARTICIPATION INFORMATION SHEET

RESEARCH TITLE: *Corporate governance practices and their impacts on corporate performance in an emerging market: The case of Sri Lanka*

PURPOSE OF THE RESEARCH:
The purpose of the research is to examine the relevance of corporate governance practices originated in developed counties to Sri Lanka, and to assess the effectiveness of existing corporate governance practices in achieving better performance and competitiveness by Sri Lankan companies.

INVESTIGATORS:

Mr. Athula Manawaduge	Dr Anura De Zoysa	Dr Kathy Rudkin
Researcher	Supervisor	Supervisor
School of Accounting & Finance	School of Accounting & Finance	School of Accounting & Finance
University of Wollongong	University of Wollongong	University of Wollongong
+61 2 4221 4711	+61 2 4221 5382	+61 2 4221 3148
athula@uow.edu.au	anura@uow.edu.au	krudkin@uow.edu.au

COOPERATION SOLICITS FROM THE PARTICIPANTS:
This is an invitation to participate in a research study conducted by researchers at the University of Wollongong. We seek your cooperation to complete a questionnaire to gather information for this research study. The survey requests your responses to questions on the current corporate governance practices in your firm and your opinion on the effectiveness of these practices. Your accurate and frank response is a key to measure the effectiveness of corporate governance practices of Sri Lankan firms.

Your involvement in the study is voluntary and you may withdraw your participation from the study at any time.

CONSENT TO PARTICIPATION
The completion and return of completed questionnaire to researchers is considered as the consent to participation in this survey.

BENEFITS OF THE RESEARCH:
This research will provide useful insights into corporate governance practices in Sri Lanka. It will formulate policy recommendations for corporate governance practices in Sri Lankan context and therefore, the outcomes of the study will be immensely beneficial to Sri Lankan companies and policy makers. Findings from this study will be reported in a thesis and conference and academic journal articles.

CONFIDENTIALITY, ETHICS REVIEW AND COMPLAINTS:

The confidentiality in relation to all data collected through the questionnaire will be assured. No information gained from this survey will be identified with name of the organisation in the report. The results will be presented only in aggregate in the research report.

The completed questionnaires will be kept securely in the lockers at the Faculty of Commerce, University of Wollongong and they can only be accessible to the members of the research team mentioned above.

This study has been continuously reviewed by the Human Research Ethics Committee (Social Science, Humanities and Behavioural Science) of the University of Wollongong. If you have any concerns or complaints regarding the way this research has been conducted, you can contact the University Ethics Officer on +61 2 4221 4457.

Thank you for your interest in this study.

Ethics Unit
Research Services Office
University of Wollongong
Wollongong NSW 2522

Appendix 6: Reminder Letter

University of Wollongong

School of Accounting & Finance
University of Wollongong
Wollongong NSW 2522 Australia
Telephone +61 2 4221 3718

20th January 2010

Dear Sir/Madam

Survey on Corporate Governance Practices of listed companies in Sri Lanka

This is further to my letter dated December 26, 2009 inviting you to participate in a research by way of completing a questionnaire on the above topic. If you have already returned the completed questionnaire I take this opportunity to thank you for your corporation. However, in case of your busy schedule did not allow you to respond to it so far, will you please send the completed questionnaire at your earliest convenience? In this regard please pay no attention to the deadline stipulated in the previous letter.

As you will agree the findings of this survey will be of immense value to the corporate sector as well as policy makers on corporate governance. Further, since this type of study requires coverage of a large cross-section of companies your participation and the views will be of utmost importance. Thus, I hope that you will extend your support in this regard.

Thank you for your co-operation.

Yours faithfully,

Athula Manawaduge
B.Sc(Mgt.), M.A.(Acc. &Fin.), ACA
Doctoral Candidate
University of Wollongong

Appendix7: Corporate Governance Index: Variables and Mean Values

Variables and Sub-indices		Marks	Reference to Questionnaire	Compliance		
				Yes	No	Mean (%)
Board Structure and Independence						**64.05**
1	Maintain balance of executive and non-executive directors	1	AR	17	43	28.33
2	Board has at least 50% non-executive directors	1	AR	47	13	78.33
3	Board has Independent directors	1	9 (i)	58	2	96.67
4	CEO is NOT chairman of the board	1	9 (iii)	46	14	76.67
5	Majority of non-executive directors are independent	1	AR	32	28	53.33
6	Selection of non-executive directors is done by the board or nomination committee	1	11	43	17	71.67
7	Non-executive directors meet without executive directors to discuss firm affairs	1	10 (v)	26	34	43.33
	Total Score	**7**				
Board Procedure and Effectiveness						**58.13**
8	Nomination committee exits	1	15 (iii)	27	33	45.00
9	Nomination Committee consists of exclusively by non-executive directors	1	19 (ii)	11	16	40.74
10	Nomination Committee chaired by an independent director	1	19 (iii)	19	8	70.37
11	Appointments to the board are made only through the nomination committee	1	20 (i)	22	38	36.67
12	Firm have formal and transparent procedures for the election of directors	1	20(ii)	46	14	76.67
13	Directors are subject to a limit on the number of simultaneous directorships	1	20(iv)	14	46	23.33
14	Firm holds four (4) or more regular board meetings per year.	1	12	56	4	93.33
15	Board meetings : Extended time period (over 2 hours)	1	13	41	19	68.33
16	Board consist of members with sufficient financial acumen	1	10 (iv)	56	4	93.33
17	Directors attend at least 75% of meetings, on average.	1	14	58	2	96.67
18	Firm has system to evaluate CEO	1	22 (i)	35	25	58.33
19	Firm has system to evaluate other executives directors	1	22 (ii)	30	30	50.00
20	Firm has system to evaluate nonexecutive directors	1	23 (i)	14	46	23.33
21	Firm has succession plan for CEO	1	22 (iii)	41	19	68.33
22	Firm has retirement age for nonexecutive directors	1	23 (ii)	28	32	46.67
23	Directors receive regular training	1	24 (iv)	23	37	38.33
24	Firm has code of ethics for directors	1	24 (i)	26	34	43.33
25	Board receives materials at least 7 days in advance	1	24 (iii)	52	8	86.67
26	CEO and board chairman are different people.	1	9 (iii)	46	14	76.67

27	Dissents are recorded in board minutes.	1	10 (iii)	55	5	91.67
28	Firm has one or more foreign outside directors.	1	9 (ii)	23	37	38.33
29	NED(s) do not receive retirement pay.	1	23 (iii)	60	0	100.00
30	Chairman hold separate meetings for non-executive directors	1	23 (v)	16	44	26.67
31	Nonexecutives can obtain professional advices at company expenses	1	23 (vi)	36	24	60.00
32	Bylaws to govern board meetings exist.	1	10 (i)	37	23	61.67
	Total Score	**25**				
Audit Committee Procedure						**85.33**
33	Audit committee exists	1	15 (i)	60	0	100.00
34	Audit committee has majority of independent directors	1	17 (iv)	52	7	88.14
35	Firm has written terms of reference governing audit committee	1	17 (i)	54	5	91.53
36	Audit committee recommends the external auditor to full board	1	17 (vii)	51	8	86.44
37	Audit committee. comprises of exclusively non-executive directors	1	17 (iii)	47	12	79.66
38	Audit committee includes someone with expertise in accounting.	1	17 (ii)	57	2	96.61
39	The committee prepare and distribute minutes for each audit committee meeting	1	17 (vi)	45	14	76.27
40	Audit committee meets four or more times per year.	1	16 (i)	40	20	66.67
41	Audit committee is chaired by an independent director	1	17 (v)	54	5	91.53
42	Audit committee meets with external auditor to review financial statements.	1	17 (ix)	52	7	88.14
	Total Score	**10**				
Directors' Remuneration Procedure						**67.92**
43	Remuneration Committee exists	1	15(ii)	58	2	96.67
44	Remuneration Committee comprises majority of independent directors	1	18 (ii)	45	13	77.59
45	Remuneration Committee chaired by an independent director	1	18 (iii)	47	11	81.03
46	Company has a written procedure or/and policies on directors' remuneration	1	18 (i)	39	19	67.24
47	Executive directors' remuneration is (at least part) performance based	1	21(v)	38	22	63.33
48	The board review CEO compensation annually	1	21(iv)	45	15	75.00
49	Long-term Incentive Schemes for Executive Directors are approved by the Shareholders	1	21(vi)	7	53	11.67
50	Dissents are recorded in the remuneration committee minutes	1	18 (v)	47	11	81.03
	Total Score	**8**				
Disclosure Substance						**66.22**
51	Related party transactions are disclosed to shareholders	1	32 (i)	60	0	100.00
52	Firm put directors buying and selling shares in the web	1	30(iv)	14	46	23.33
53	Firm puts quarterly financial statements on	1	30 (i)	33	27	55.00

	web					
54	Firm puts annual report on web	1	30 (ii)	37	23	61.67
55	Firms put directors' report on web	1	30 (iii)	34	26	56.67
56	Firm puts corporate governance report on web	1	31(v)	7	53	11.67
57	Firm put Statement of Corporate Governance in Annual reports	1	31(v)	60	0	100.00
58	Audit Committee Report in Annual reports	1	31 (viii)	54	6	90.00
59	Remuneration Committee Report in Annual reports	1	31 (ix)	44	16	73.33
60	Nomination Committee Report in Annual reports	1	31 (x)	18	9	66.67
61	Risk Management Policies and Process	1	31(iv)	49	11	81.67
62	Membership of Audit, Remuneration and Nomination Committees	1	31(vii)	58	2	96.67
63	Resume of directors	1	31(ii)	60	0	100.00
64	Disclosure of Directors' Remuneration	1	31 (iii)	17	43	28.33
65	Disclosure of Audit and Non-audit fees separately	1	31 (vi)	51	9	85.00
	Total Score	**15**				
Disclosure Reliability						**81.33**
66	Non-audit fees are < 20% of total auditor fees or no non-audit services	1	26 (iv) & 27	42	18	70.00
67	Full board reviews auditor's recommendations	1	26 (iii)	57	3	95.00
68	Audit partner is rotated every 5 years	1	26 (ii)	41	19	68.33
69	Audit committee recommends the external auditor to full board	1	17 (vii)	51	8	86.44
70	Audit committee conduct a formal review of the auditor's work	1	26 (i)	53	7	88.33
	Total Score	**5**				
Related Party Transactions						**57.92**
71	Firm does not have loans to insiders	1	32(iii)	50	10	83.33
72	Firm does not have significant sales to or purchases from insiders	1	32(iv)	47	13	78.33
73	Firm does not rent real property from or to an insider	1	32 (v)	47	13	78.33
74	Firm had negligible revenue from RPTs (0-1% of sales)	1	33	25	35	41.67
75	RPTs are reviewed by the board in the last year	1	32 (vi)	49	11	81.67
76	Related party transactions are on arms-length terms	1	32 (ii)	53	7	88.33
77	RPTs with executives approved by non-conflicted directors or audit committee	1	34	4	56	6.67
78	RPTs with controlling shareholders approved by non-conflicted directors or AC	1	35	3	57	5.00
	Total Score	**8**				
Shareholder Rights						**79.58**
79	There is no deviation from the one share-one vote rule	1	25 (ix)	54	6	90.00
80	Directors serve three-year terms	1	20 (iii)	56	4	93.33

81	Firm allows voting by mail	1	25 (i)	17	43	28.33
82	Anybody can serve as a proxy	1	25 (ii)	58	2	96.67
83	There is no extraordinary meeting on shareholders' request in last 3 years	1	25 (iii)	54	6	90.00
84	Board has one or more minority shareholder representatives	1	8 (ii)	24	36	40.00
85	Firm discloses director candidates to shareholders prior to AGM	1	25 (iv)	43	17	71.67
86	Adequate time is given to shareholders for asking questions at the AGM.	1	25(vi)	60	0	100.00
87	Chairpersons of Committees are available at the AGM to answer questions	1	25 (v)	57	3	95.00
88	Shareholders' priority subscription right in the issuance of shares is adequately protected	1	25(ii)	58	2	96.67
89	RPTs are fully discussed with adequate information at the shareholders' meeting	1	25 (viii)	58	2	96.67
90	There are written guidelines in respect of directors' share dealings of the firm	1	24 (ii)	34	26	56.67
	Total Score	**12**				

Appendix 8: Perception Survey Questionnaire and Cover Letter

University of Wollongong

School of Accounting & Finance
University of Wollongong
Wollongong NSW 2522 Australia
Telephone +61 2 4221 3718

02 January 2010

Dear Sir/Madam,

Questionnaire Survey on Corporate Governance Practices in Sri Lanka

This is an invitation to participate in a research study at the University of Wollongong, Australia. As a part of my doctoral study, I am currently undertaking a research project on corporate governance practices in Sri Lanka.

Corporate governance is the system by which corporate entities are directed and controlled. Given the recent high profile corporate scandals in Sri Lanka, the effectiveness of the existing corporate governance system has been questioned by various constituent groups in the country. The main purpose of my study is to identify the key problems and to assess the effectiveness of the existing corporate governance system in Sri Lanka.

I solicit your cooperation in this research by completing the attached questionnaire which will take approximately 15-20 minutes. Your co-operation in this regard is greatly appreciated. Please send the completed questionnaire using the self addressed envelope enclosed by 20th January 2010. I look forward to receiving your completed questionnaire and if you have any query regarding the research or questionnaire, please contact me on 0779371170 or e-mail athula@uow.edu.au .

Thank you for your co-operation.

Yours faithfully,

Athula Manawaduge
B.Sc (Mgt.), M.A.(Acc. &Fin.), ACA
Doctoral Candidate
University of Wollongong

University of Wollongong NSW 2522 Australia
www.uow.edu.au

A Questionnaire Survey on Corporate Governance in Sri Lanka

Part – I: Participant Information

1 Please indicate [✓] your occupation.

- ☐ Director/Executive in a company
- ☐ Partner/ Manager/ Senior in an audit firm
- ☐ Fin. Manager/Accountant in a company
- ☐ Manager/Executive in the Govt.
- ☐ Lecturer / Researcher
- ☐ Audit Superintendent/Audit officer
- ☐ Assessor/ Tax officer
- ☐ Banker/Executive in a bank
- ☐ Financial analysts
- ☐ Investor

2 Gender
- ☐ Male
- ☐ Female

3 Professional Qualifications
- ☐ None
- ☐ MAAT/SAT, ICA / CIMA/ACCA parts,
- ☐ ICASL/ICMA/ CIMA/ACCA membership
- ☐ Attorney at law
- ☐ Other (Please Specify):

4 Highest Educational qualification (Tick one box.)
- ☐ School Level
- ☐ Diploma
- ☐ Bachelor's Degree
- ☐ Post Gradate Diploma
- ☐ Master's Degree
- ☐ Doctoral Degree
- ☐ Other (Please specify):

5 How long have you been in your present profession?
- ☐ Less than one year
- ☐ 1 – 5 years
- ☐ 5 – 10 years
- ☐ 10 – 15 years
- ☐ 15 - 20 years
- ☐ Over 20 years

6 In how many companies have you purchased shares?
- ☐ None
- ☐ One company
- ☐ 2 – 5 companies
- ☐ 6 – 10 companies
- ☐ 11 - 20 companies
- ☐ Over 20 companies

7. Do you have experience in serving as a director of a public limited company? Yes ☐ No ☐

Part –II: Corporate Governance: Components and Performance Implications

Please **tick** on a scale from **1 - 5** to indicate the extent of your agreement with the given statements.

8. The corporate governance system of a country should include:	Strongly Disagree				Strongly Agree
(i) Companies' internal management structure and the board	1	2	3	4	5
(ii) Companies' internal management regulations, policies and procedures	1	2	3	4	5
(iii) Judiciary system of the country	1	2	3	4	5
(iv) Regulatory framework including monitoring institutions of the country	1	2	3	4	5
(v) Financial reporting framework of the country	1	2	3	4	5
(vi) Ownership structure of the companies	1	2	3	4	5
(vii) Code of best practices of corporate governance	1	2	3	4	5
(viii) Corporate culture and practices	1	2	3	4	5
(ix) Relationship among core stakeholders	1	2	3	4	5
(x) Code of conduct and ethics applicable in business	1	2	3	4	5
(xi) Culture and value system of the society	1	2	3	4	5

9. Do you agree that better corporate governance will have the following impacts on a company's performance?

		Strongly Disagree				Strongly Agree
(i)	Improve financial performance	1	2	3	4	5
(ii)	Improve ability to generate equity capital	1	2	3	4	5
(iii)	Improve access to new capital	1	2	3	4	5
(iv)	Increase market value of shares	1	2	3	4	5
(v)	Reduce share price volatility	1	2	3	4	5
(vi)	Reduce political or regulatory intervention	1	2	3	4	5
(vii)	Reduce cost of capital	1	2	3	4	5
(viii)	Improve corporate social responsibility	1	2	3	4	5

Part –III: Sri Lankan Corporate Governance: Current Status and Major Issues

10. Do you agree with the following statements about Corporate Governance (CG) in Sri Lanka?

		Strongly Disagree				Strongly Agree
(i)	The standard of CG in Sri Lanka is comparable to that of a developed country.	1	2	3	4	5
(ii)	The standard of CG in Sri Lanka is comparable to that of Asian countries.	1	2	3	4	5
(iii)	The existing CG regulations are adequate to ensure good CG in Sri Lanka.	1	2	3	4	5
(iv)	The existing CG regulations are effectively implemented by most Sri Lankan firms.	1	2	3	4	5
(v)	Regulatory monitoring of CG compliance is adequate.	1	2	3	4	5
(vi)	The Colombo Stock Exchange should have introduced more rigorous CG rules.	1	2	3	4	5
(vii)	Most listed companies have already taken measures to strengthen their CG.	1	2	3	4	5
(viii)	Most listed companies in Sri Lanka could have done more to strengthen CG.	1	2	3	4	5
(ix)	The interests of minority investors are adequately protected in Sri Lanka.	1	2	3	4	5

11. Indicate to what extent you regard the following CG issues as either major or minor issues in Sri Lanka?

		Minor Issue			Major Issue	
(i)	Lack of integrity and ethics among top management	1	2	3	4	5
(ii)	Lack of transparency in financial reporting	1	2	3	4	5
(iii)	Insider trading (directors artificially control share prices for personal gain)	1	2	3	4	5
(iv)	Inadequate protection of minority shareholders' rights	1	2	3	4	5
(v)	Conflicts of interest of directors	1	2	3	4	5
(vi)	Drain off of funds through associate or subsidiary companies	1	2	3	4	5
(vii)	Independent directors do not exercise true independence in decision making	1	2	3	4	5
(viii)	Inadequate and inefficient risk management	1	2	3	4	5
(ix)	Lack of transparency about directors' remuneration	1	2	3	4	5
(x)	Lack of proper balance between executive and non-executive directors in the board	1	2	3	4	5
(xi)	Ineffective connectivity between board and management	1	2	3	4	5

Part –IV: Sri Lankan Corporate Governance: Strategies and Practices

12. Indicate the importance you place on the following corporate governance strategies in improving corporate governance practices in Sri Lanka.

		Less Important			More Important	
(i)	Making the internal corporate governance mechanisms work better (E.g. effective board functions, active shareholder participation etc.)	1	2	3	4	5
(ii)	Making the external corporate governance mechanisms work better (E.g. enact specific regulations, monitoring, facilitating hostile acquisitions etc.)	1	2	3	4	5
(iii)	Enhancing the standards of accounting, audit and disclosures	1	2	3	4	5
(iv)	Conducting and publicizing corporate governance ratings of companies	1	2	3	4	5
(v)	Prohibiting or tightly controlling some types of related-party transactions (E.g. lending to directors, cross-guarantees of repayment etc)	1	2	3	4	5
(vi)	Reducing ownership concentration (E.g. tighter control on cross-shareholding and pyramid ownership structure etc)	1	2	3	4	5

13. Do you agree that the corporate governance of Sri Lankan companies can be improved by adhering to following practices?

		Strongly Disagree			Strongly Agree	
(i)	Giving the audit committee greater power to investigate financial reporting	1	2	3	4	5
(ii)	Full disclosure of related party transactions	1	2	3	4	5
(iii)	Not obtaining audit and non-audit services from the same provider	1	2	3	4	5
(iv)	The CEO and Chairman positions are not held by the same person	1	2	3	4	5
(v)	Remuneration packages for executive directors are closely tied to performance	1	2	3	4	5
(vi)	Key advisory committees are composed entirely of independent directors	1	2	3	4	5
(vii)	There should be an age limit for directors	1	2	3	4	5
(viii)	Independent directors should make up at least one-half of the board	1	2	3	4	5
(ix)	Independent directors should be independent of both management And major shareholders	1	2	3	4	5
(x)	Full disclosure of the recruitment policy of new directors	1	2	3	4	5
(xi)	Full disclosure of the remuneration policy for executive directors	1	2	3	4	5
(xii)	The exact remuneration of each director should be disclosed in the annual reports	1	2	3	4	5
(xiii)	Imposed limitations on the number of directorships held by a director at one time	1	2	3	4	5
(xiv)	Adoption of a code of conduct and ethics for all directors, officers and employees	1	2	3	4	5

Part –V: Sri Lankan Corporate governance: Key Players and Promotion

14. Do you agree that the following institutions and groups are carrying out their role efficiently to improve corporate governance practices in Sri Lanka?

		Strongly Disagree				Strongly Agree
(i)	Securities and Exchange Commission of Sri Lanka	1	2	3	4	5
(ii)	Colombo Stock Exchange	1	2	3	4	5
(iii)	Financial supervisory agencies (e.g. Central Bank)	1	2	3	4	5
(iv)	The Institute of Chartered Accounts of Sri Lanka	1	2	3	4	5
(v)	Other professional accounting institutions	1	2	3	4	5
(vi)	The judiciary	1	2	3	4	5
(vii)	Sri Lanka Institute of Directors	1	2	3	4	5
(viii)	Outside directors (Non-executive and independent directors)	1	2	3	4	5
(ix)	Civil activists (such as investors association, minority shareholder etc)	1	2	3	4	5
(x)	(Financial) press and other media	1	2	3	4	5

15. In your opinion what approach is suitable to promote good corporate governance practices in Sri Lankan firms? (Please tick one option)

- ☐ Prescriptive approach: Prescription of specific corporate governance rules and practices by regulations.
- ☐ Non- prescriptive approach: Allowing companies to determine their own corporate governance practices
- ☐ Mixed approach: Prescription only the basic framework by regulations and allowing companies to develop more detailed practices by their own (based on voluntary governance code)

16. In your opinion, what are the other major corporate governance problems or issues faced by Sri Lankan companies?

17. Other comments and recommendations that you would like to make to improve corporate governance in Sri Lanka.

Part –VI: Personal Information (Optional)

I. Name:

II. Designation:

III. Name of the Organization:

THANK YOU FOR COMPLETING THE QUESTIONNAIRE

Appendix 9: Test of Non-response Bias

	Major Component of Corporate Governance		N	Mean	Std. Dev.	Sig.*
I	Companies' internal management structure and the board	1	105	3.92	.987	.934
		2	32	3.91	1.228	.941
II	Companies' internal management regulations, policies and procedures	1	105	3.97	.975	.650
		2	32	3.88	1.264	.693
III	Judiciary system of the country	1	105	3.63	1.265	.397
		2	32	3.84	1.221	.391
IV	Regulatory framework including monitoring institutions of the country	1	105	4.10	.946	.735
		2	32	4.03	.897	.729
V	Financial reporting framework of the country	1	104	4.10	.887	.615
		2	32	4.19	.931	.626
VI	Ownership structure of the companies	1	106	3.58	1.186	.668
		2	32	3.69	1.176	.668
VII	Code of best practices of corporate governance	1	105	4.24	1.033	.922
		2	32	4.22	.751	.908
VIII	Corporate culture and practices	1	106	3.86	1.064	.832
		2	32	3.81	1.091	.834
IX	Relationship among core stakeholders	1	106	3.73	.900	.647
		2	32	3.81	1.030	.672
X	Code of conduct and ethics applicable in business	1	106	4.07	1.007	.646
		2	32	4.16	.847	.616
XI	Culture and value system of the society	1	106	3.73	1.143	.601
		2	32	3.844	.987	.573
	Performance implication					
I	Improve financial performance	1	106	4.085	.896	.442
		2	32	3.94	1.105	.494
II	Improve ability to generate equity capital	1	107	3.93	.914	.510
		2	33	4.06	1.088	.549
III	Improve access to new capital	1	108	3.87	.887	.023
		2	32	4.28	.888	.026
IV	Increase market value of shares	1	107	4.01	.906	.710
		2	33	3.94	1.059	.733
V	Reduce share price volatility	1	107	3.52	.925	.715
		2	33	3.45	1.003	.727
VI	Reduce political or regulatory intervention	1	107	3.76	1.026	.063
		2	33	3.36	1.141	.083
VII	Reduce cost of capital	1	107	3.48	1.031	.580
		2	33	3.36	.994	.574
VIII	Improve corporate social responsibility	1	108	4.25	.822	.549
		2	33	4.15	.834	.554
	Status of Corporate governance in Sri Lanka					
I	The standard of CG in Sri Lanka is comparable to that of a developed country.	1	108	2.53	1.018	.949
		2	33	2.52	.906	.946
II	The standard of CG in Sri Lanka is comparable to that of Asian countries.	1	108	3.29	.967	.288
		2	33	3.09	.765	.232
III	The existing CG regulations are adequate to ensure good CG in Sri Lanka.	1	107	2.77	1.104	.060
		2	33	2.36	.929	.042
IV	The existing CG regulations are effectively implemented by most of the Sri Lankan firms.	1	106	2.48	.897	.139
		2	32	2.22	.792	.117
V	Regulatory monitoring of CG compliance is adequate.	1	108	2.58	1.033	.079
		2	33	2.24	.708	.035
VI	The Colombo Stock Exchange should have introduced	1	107	3.36	.925	.417

	more rigorous CG rules.	2	33	3.52	.939	.423
VII	Most listed companies in Sri Lanka have already taken	1	108	3.21	.774	.071
	measures to strengthen their CG.	2	32	2.94	.669	.054
VIII	Most listed companies in Sri Lanka could have done	1	107	3.69	.829	.703
	more to strengthen their CG.	2	32	3.63	.976	.728
IX	The interests of minority investors are adequately	1	107	2.53	1.031	.948
	protected in Sri Lanka.	2	33	2.55	.794	.941
	Major Issues of Corporate Governance					
I	Lack of integrity and ethics among top management	1	107	3.93	.997	.466
		2	33	3.79	.740	.396
II	Lack of transparency in financial reporting	1	108	3.94	.874	.358
		2	33	3.79	.781	.331
III	Insider trading (directors artificially control share prices	1	108	3.74	.961	.804
	for personal gain)	2	33	3.79	.927	.801
IV	Inadequate protection of minority shareholders' rights	1	108	3.72	.915	.633
		2	33	3.64	.859	.623
V	Conflicts of interest of directors	1	108	3.68	.994	.674
		2	33	3.76	.902	.659
VI	Drain off of funds through associate or subsidiary	1	107	3.90	.800	.625
	companies	2	33	3.82	.846	.637
VII	Independent directors do not exercise true independence	1	108	3.86	1.009	.806
	in decision making	2	33	3.91	.879	.792
VIII	Inadequate and inefficient risk management	1	108	3.79	.918	.497
		2	33	3.91	.843	.479
IX	Lack of transparency about directors' remuneration	1	108	3.81	.987	.117
		2	33	3.52	.834	.089
X	Lack of proper balance between executive and non-	1	108	3.60	.937	.423
	executive directors in the board	2	33	3.45	.869	.406
XI	Ineffective connectivity between board and management	1	108	3.69	.837	.871
		2	33	3.67	.924	.878
	Corporate Governance Strategies					
I	Making the internal corporate governance mechanisms	1	108	4.08	.844	.333
	work better	2	33	4.24	.751	.306
II	Making the external corporate governance mechanisms	1	108	4.03	.814	.574
	work better	2	33	4.12	.893	.594
III	Enhancing the standards of accounting, audit and	1	106	4.14	.920	.769
	disclosures	2	33	4.09	.631	.722
IV	Conducting and publicizing corporate governance ratings	1	107	4.00	.836	.855
	of companies	2	32	3.97	.897	.861
V	Prohibiting or tightly controlling some types of related-	1	106	3.90	.925	.367
	party transactions	2	33	4.06	.864	.352
VI	Reducing ownership concentration	1	108	3.59	1.014	.028
		2	33	4.03	.918	.023
	Governance Practices need improvements					
I	Giving the audit committee greater power to investigate	1	107	3.98	.879	.308
	financial reporting	2	33	4.15	.667	.241
II	Full disclosure of related party transactions	1	107	4.09	.864	.017
		2	33	4.48	.619	.005
III	Not obtaining audit and non-audit services from the same	1	108	3.81	1.036	.415
	provider	2	33	3.97	.918	.387
IV	The CEO and Chairman positions are not held by the	1	106	3.97	1.046	.140
	same person	2	33	4.27	.911	.115
V	Remuneration packages for executive directors are	1	106	3.95	.844	.801
	closely tied to performance	2	33	3.91	.947	.813

VI	Key advisory committees are composed entirely of independent directors	1	106	3.78	.995	.627
		2	33	3.88	.960	.622
VII	There should be an age limit for directors	1	106	3.11	1.312	.017
		2	33	3.73	1.126	.011
VIII	Independent directors should make up at least one-half of the board	1	107	3.44	1.002	.174
		2	33	3.73	1.232	.227
IX	Independent directors should be independent of both management and major shareholders	1	107	4.09	.906	.741
		2	33	4.15	.795	.724
X	Full disclosure of the recruitment policy of new directors	1	107	3.79	.789	.982
		2	32	3.78	1.008	.984
XI	Full disclosure of the remuneration policy for executive directors	1	108	3.80	.806	.680
		2	33	3.73	.944	.706
XII	The exact remuneration of each director should be disclosed in the annual reports	1	108	3.48	1.164	.909
		2	33	3.45	1.252	.913
XIII	Imposed limitations on the number of directorships held by a director at any one time	1	108	3.61	1.058	.109
		2	33	3.94	.899	.084
XIV	Adoption of a code of conduct and ethics for all directors, officers and employees	1	107	4.32	.784	.635
		2	33	4.39	.864	.653
	Key players and Promoters					
I	Securities and Exchange Commission of Sri Lanka	1	108	3.28	.874	.244
		2	33	3.48	.939	.265
II	Colombo Stock Exchange	1	108	3.49	1.857	.799
		2	33	3.58	.830	.712
III	Financial supervisory agencies (e.g. Central Bank)	1	108	3.17	1.098	.434
		2	33	3.33	.957	.402
IV	The Institute of Chartered Accounts of Sri Lanka	1	108	3.33	1.005	.450
		2	33	3.48	1.004	.451
V	Other professional accounting institutions	1	104	2.97	.908	.519
		2	32	3.09	1.027	.547
VI	The judiciary	1	107	2.99	.927	.179
		2	33	3.24	.969	.193
VII	Sri Lanka Institute of Directors	1	105	2.81	.722	.477
		2	32	2.69	1.176	.582
VIII	Outside directors (Non-executive and independent directors)	1	105	2.84	.722	.360
		2	32	2.69	1.061	.457
IX	Civil activists (such as investors association, minority shareholder etc)	1	106	2.60	.869	.733
		2	33	2.67	1.080	.762
X	Financial press and other media	1	107	2.82	1.053	.450
		2	33	2.67	.957	.428