CORPORATE GOVERNANCE OF SRI LANKAN LISTED COMPANIES: SIGNIFICANT FEATURES AND ISSUES

Samanthi Senaratne *
P. S. M. Gunaratne **

Abstract

This study examines the significant features and associated issues of corporate governance practices of Sri Lankan listed companies based on their level of compliance with internationally accepted corporate governance best practices. The study finds both positive and negative features in corporate governance practices of Sri Lankan companies based on the extent of their compliance with best practices. The positive features refer to the increasing convergence in corporate governance practices of these companies with the best practices on the role, composition and diligence of the board of directors; internal financial controls and internal audit; and appointment of an audit committee to oversee financial reporting and audit. These positive features indicate that the directors of Sri Lankan companies fulfil both performance and conformance roles, and certain mechanisms required for the effective discharge of their functions are in operation in these companies. On the other hand, the negative features refer to the non-compliance of most companies with the best practice requirements of the independence of non-executive directors and board committee membership, and appointment of a nomination committee and a remuneration committee respectively to oversee the board appointments and the determination of directors' remuneration. These negative features act as an inhibitor in realising the full benefits of the positive features of corporate governance practices, and reduce the professional character and independence of the board which are necessary requirements for the directors to supervise the management effectively. Further, these negative features are strongly associated with the presence of a controlling shareholder in most Sri Lankan listed companies, inadequacies in the legal structure and to some extent with the lack of political governance in the country.

Key Words: corporate governance, best practice, directors, features, issues

Introduction

The term 'corporate governance', which refers to how a company is governed, has succeeded in attracting a great deal of public interest over the years because of its apparent importance for the economic health of companies and society in general in both developed and developing countries. The roots of the corporate governance movement can be traced to the publication of *The Modern Corporation and Private Property* by Adolf A. Berle and Gardiner C. Means in 1932, which argued that dispersion of equity ownership in the modern corporate entities had separated ownership from control. Based on the seminal summary of Berle and Means (1932)

* Senior Lecturer, Department of Accounting, Faculty of Management Studies and Commerce, University of Sri Jayewardenepura, Sri Lanka
** Senior Lecturer, Faculty of Management and Finance, University of Colombo, Sri Lanka

and extensions made by agency theorists like Jensen and Mackling (1976), who focused on the behaviour of a self-serving agent, the evolution of corporate governance has been described in terms of the separation of ownership and control between the shareholders (owners) and the managers in corporate entities (Chandler, 1977; Galbraith, 1967; Fligstein, 1990). Hence, corporate governance aims to align the divergence of interests that could arise between the shareholders and the managers due to the separation of ownership and control of corporate entities. The board of directors is pivotal in the relationship between shareholders and the management as directors are appointed by the shareholders to oversee the management on their behalf to ensure that they act in the best interest of shareholders. Hence, the roles and responsibilities of the board underpin the task of corporate governance.

On the other hand, corporate governance received much attention in the recent past owing to several reasons associated with economic reforms in countries and accidents of history such as regional market failures and mega corporate debacles. Becht, Bolton and Roell (2005) identify these reasons as the worldwide wave of privatization of the past two decades; pension fund reform and the growth of private savings; the takeover wave of the 1980s; deregulation and the integration of capital markets; the East Asia crisis in 1998 with which corporate governance in emerging markets came into the limelight; and the high-profile corporate debacles in many parts of the world including the USA during 2000-2001. Therefore, various initiatives have been taken internationally to develop best practices in corporate governance and thereby to improve the governance practices of corporate entities. This shows that the impetus for corporate governance reforms has deeper roots that relate to the structural changes in the global economy and historical experiences of countries as to market and corporate failures. Although corporate governance has become a global imperative, still there is no universally accepted model or system of corporate governance.

The Asian financial crisis vividly exposed the damage created by poor corporate governance practices in Asian firms with far-reaching implications for the economies of these countries. Hence, during the Asian financial crisis, a lot of the attention fell upon the corporate governance systems of emerging markets, which have a tendency towards cronyism and nepotism. Thus, corporate governance has become an important policy issue today in the emerging markets like Sri Lanka. In the Sri Lankan context too, a considerable effort has been made to enhance the efficacy of corporate governance practices especially of listed (publicly traded) companies. This is due to the emergence of the corporate sector as a dominant force in the Sri Lankan economy with the introduction of the open economy policy in 1977 by the then government and its continuation by successive governments. The notable feature of corporate governance reforms in Sri Lanka is the close allegiance to the Anglo-Saxon Model of Corporate Governance (especially with the British Model) mainly as a legacy of British colonial rule in the country for nearly 150 years (Senaratne and Gunaratne 2007a). However, it is questionable whether the provisions of the corporate governance codes of these developed countries will be applicable in the Sri Lankan context in the same way that they have been practised in those countries. This is mainly owing to the differences in the socio-economic underpinnings of Sri Lanka from those of developed countries. Further, every company could have its own unique history, culture and business goals, which could have a considerable impact on their governance practices.

In this context, the present study examines the significant features of corporate governance practices of Sri Lankan listed companies and associated issues. The significant features are examined in relation to the extent of compliance of Sri Lankan listed companies with internationally accepted corporate governance best practices. As the development of corporate governance practices is context specific to a certain extent, the study also examines the issues associated with the introduction or implementation of these best practices in the Sri Lankan context. Hence, this examination would help to understand the current state of governance practices of Sri Lankan listed companies.

The significance of the study can be discussed in both general and specific terms for promoting the development of a country. With globalisation and the wave of deregulation, corporate entities have become a principal agent of development in most countries of the world. Hence, improvements in corporate governance could yield economic benefits to countries through the efficient allocation of resources in the economy and ensuring macro economic stability. Further, the development impact of corporate governance provides important insights into future economic reforms of countries.

The remainder of the paper is organised as follows: Section 2 provides the theoretical background of the study. Section 3 describes the methodology used in the study to examine its objective. Section 4 presents and discusses the findings of the study highlighting the country specific features. Section 5 concludes with recommendations for future research.

Theoretical Background of the Study

The theoretical basis for the study has been derived from the corporate governance best practices, which focus on the best way of achieving the desired outcome. There are a number of global initiatives for the development of corporate governance best practices and they include OECD Principles of Corporate Governance (1999 and 2004), corporate governance codes developed in UK (Cadbury Report 1992 on Financial Aspects of Corporate Governance, Greenbury Report 1995 on Directors' Remuneration, Combined Code on Corporate Governance - Hampel Report 1998, Turnbull Report 1999 on Internal Controls, Audit Committees Combined Code Guidance - Smith Report 2003, Review of the Role and Responsibilities of Non-Executive Directors - Higgs Report 2003 and Combined Code 2003, which replaced the Combined Code 1998) and USA corporate governance initiatives (COSO Frameworks-1992 and 2003 on Internal Controls, and Sarbanex-Oxley Act 2002). The OECD Principles represent a common basis for its member countries (as well as non-member countries) to consider as essential for the development of good governance practices and their use as the basis of developing national corporate governance codes. These principles cover the following areas: ensuring the basis for an effective corporate governance framework; the rights of shareholders and key ownership functions; the equitable treatment of shareholders; the role of stakeholders; disclosure and transparency; and the responsibilities of the board. On the other hand, the codes of best practice developed in the UK and USA address the basic issues of board effectiveness and accountability through the strengthening of shareholder influence, and control by boards over their companies. Hence, the key aspects addressed in these codes are board independence, adequacy of controls and transparency. A comparison of these international principles and codes highlights that they ultimately aim at the same objective (i.e. to produce effective corporate management and efficient resource allocation) though they possess a very different architecture and ways of delivering those results.

The first Sri Lankan Code of Best Practice on Corporate Governance was developed in 1997 by the Institute of Chartered Accountants of Sri Lanka (ICASL), the national professional accounting body, to deal with financial aspects of corporate governance of Sri Lankan listed companies. It was largely derived from the Cadbury Code (1992) of UK. This Code was replaced by the ICASL Code of Best Practice on Corporate Governance introduced in March 2003 and is largely based on the Hampel Report (1998) of UK. Its focus is much larger as it covers all aspects of corporate governance (i.e. board effectiveness, directors' remuneration, accountability and audit, relations with shareholders and institutional shareholders) and not only financial aspects. Both are voluntary codes of corporate governance best practices which only make recommendations as to good corporate governance practices. Hence, Sri Lankan companies complied with the provisions of these codes voluntarily. However, this situation is expected to be changed in the future with the incorporation of corporate governance rules into the Listing Rules of the Colombo Stock Exchange (CSE) in 2007 and the compliance with these is mandatory for listed companies from April 2008. These rules cover the following aspects: appointment of non-executive directors; independence of non-executive directors; remuneration committee; audit committee; and disclosures relevant to these four areas. These provisions have also been largely derived from international corporate governance codes especially of UK Combined Code 2003, which had been developed by incorporating the recommendations of Turnbull, Higgs and Smith Committee Reports published subsequent to the Hampel Report. Hence, the Sri Lankan corporate governance codes have been developed in line with internationally accepted corporate governance best practices particularly those that have been developed in line with the Anglo-Saxon Model (Market Model) of Corporate Governance.

Much of the focus of the codes on best practices described above is on making recommendations on the conduct of the board of directors for the effective discharge of their responsibilities because of its central role in corporate governance due to the separation of ownership and control in companies. The responsibilities of the board include providing strategic guidance to the company, effective monitoring of management, and accountability of the board to the company and to shareholders. Hence, the best practices set out the responsibilities of the board in general and specific responsibilities of the board in ensuring shareholders' rights, disclosure and transparency.

Although there is an increasing clamour for the adoption of corporate governance best practices, there are also certain differences in governance practices of individual countries. These differences usually arise as part of the cultural integrity and economic dynamism of the country in question. Accordingly, different systems of corporate governance have been developed in the world and they are broadly classified into two groups as the outside system of market-based corporate governance prevailing in Anglo-Saxon countries and inside system of relationship-based corporate governance in Continental European and Asia-Pacific Countries (Sheard, 1998;Weimer & Pape, 1999). The key distinction between the two systems is made in terms of who plays the dominant role in monitoring and control of a company (i.e., whether banks or the stock market is the main locus of monitoring and control). Gay (2002) explains the key characteristics of the Anglo-Saxon Model as follows: (1) One principal stakeholder, the shareholder, generally exerts more influences than other stakeholders on managerial decision making; the company and its board of directors are seen as instruments for the creation of shareholder wealth; (2) A one-tier board of directors (unitary board) where executive and supervisory responsibilities of the board are condensed in one legal entity. There are executive and non-executive directors, with both classes being appointed and dismissed by the general assembly of shareholders; (3) Stock markets play a more important role than they do in the other groups of countries; (4) There is an active market for corporate control and takeovers are a common occurrence; (5) With regard to concentration of ownership, companies are relatively widely held; (6) With regard to executive compensation, performance dependent schemes are common, and (7) The system of corporate governance is characterized by relatively short-term economic relationships. This model has been characterized normally as disclosure based because dispersed investors require reliable and adequate information flows in order to make informed investment decisions.

The development of international corporate governance codes while there are different systems of corporate governance in the world indicates that both convergence and divergence in corporate governance practices can occur simultaneously. Sri Lankan companies too cannot be immune from the influence of these different systems and international developments in corporate governance codes (Senaratne and Gunaratne 2007a). Hence, a study of corporate governance should focus on these issues.

Methodology

The study uses a combination of quantitative and qualitative methods of analysis. The quantitative analysis examines the significant features of corporate governance practices in Sri Lankan listed companies in terms of their level of compliance with the internationally accepted corporate governance best practices. The qualitative analysis supplements the quantitative analysis through a descriptive analysis of significant corporate governance features and associated issues in Sri Lankan companies by drawing inferences from the extant literature with special emphasis on the literature relevant to other emerging markets.

The quantitative analysis was carried out *via* the Corporate Governance Index developed in the study. It consists of pre-determined criteria based on the principles of corporate governance identified from the ICASL Code of Best Practices (2003) to measure the level of corporate governance of Sri Lankan companies. Based on these principles, the Corporate Governance Index covers best practices on board effectiveness (BE), risk management processes and internal controls (RMIC), audit committee characteristics (AC) and directors' remuneration (DR), which represent the sub components of the Index. The total number of variables covered in the Index under these four components is 39, comprising 20 variables under BE, 6 under RMIC, 7 under AC and 6 under DR.

The variables under BE focus on the composition, independence, functions and diligence of the board, appointments to the board (including performance evaluation and succession planning), and professional development of directors. The variables under RMIC focus on risk management strategy and system of internal controls including the internal audit. AC deals with the appointment, composition, authority and responsibility of the audit committee and DR deals with the same in respect of the remuneration committee. This is an equal weighted index where two marks are assigned for full compliance with a best practice provision, one mark for partial compliance and zero marks for non-compliance. Hence, the maximum mark of each sub component is equal to the number of variables covered under it multiplied by 2 and the total index value is equal to 78 (i.e., 39 variables multiplied by 2). The total value of the index (CG) denotes the maximum possible level of compliance with the best practice. Based on this Index, total and sub component corporate governance scores of sample companies were calculated annually over the sample period to identify the extent to which companies have complied with the best practice. Thereafter, the behaviour and variations of scores over the sample period were analysed using a one-sample t-test, and paired sample t-test. This analysis was supplemented by a detailed analysis of the individual variables of the Corporate Governance Index based on the level of compliance of sample companies.

This study is based on a sample of companies listed in the CSE and the sample period of the study is five years from 2000-2004, a period which experienced a renewed interest in the subject of corporate governance associated with significant market and corporate failures that occurred in the world. Of the total number of companies listed in the CSE at the end of 2004 (i.e., 242), the following were excluded in selecting the sample of the study due to the non-availability of data for the whole sample period: (1) those listed during the sample period (i.e. 26) and (2) those in the default board for two or more consecutive years (i.e. 22). Hence, the total number of companies that qualified for sample selection was equal to 194 and thereafter, a sample of 60 companies was selected to represent approximately $^1/_3$ of the number that qualified for sample selection randomly based on probability proportionate sampling. The data required for the study was obtained from corporate governance disclosures provided in the annual reports of sample companies and their parent companies.

Findings and Discussion

Compliance with the Corporate Governance Best Practices

The compliance of Sri Lankan companies with the corporate governance best practices was assessed on total and sub component corporate governance scores of sample companies based on the Corporate Governance Index of the study. These scores represent an increasing trend during the sample period as shown in Table 1 and the trend is statistically significant. This shows a general inclination in Sri Lankan companies to improve their governance practices in line with internationally accepted best practices, particularly in line with the Anglo-Saxon Model. As Sri Lankan companies voluntarily complied with the corporate governance best practices during the sample period, this increasing trend also highlights a functional convergence of corporate governance practices, which refers to more decentralised, market-based and firm-level changes irrespective of legal reforms (Coffee, 1999).

Table 1: Movement in Annual Average Corporate Governance Scores during the Sample Period

This Table shows the actual annual averages of total corporate governance score (CG) and four sub components scores: board effectiveness (BE); risk management processes and internal controls (RMIC); audit committee characteristics (AC) and directors' remuneration (DR). The statistical significance of the movement of these scores was examined based on a paired-sample t-test.

Variable	Max. Possible Score	Actual Score					Mean diff. between 2000 & 2004	t-stat.	p-value
		2000	2001	2002	2003	2004			
BE	40	14	14	15	17	17	3.4	6.59	0.00
RMIC	12	4	6	6	7	7	2.7	5.60	0.00
AC	14	2	3	4	4	5	2.47	4.95	0.00
DR	12	2	2	2	4	4	2.45	5.46	0.00
CG	78	22	25	27	32	33	10.89	6.96	0.00

Although the difference between the mean total corporate governance scores of companies and the index value has declined considerably over the period, there is still a fairly significant gap between the two and the gap is statistically significant as indicated in Table 2. Further, there is a wide gap between maximum and minimum total corporate governance scores of the sample. This highlights significant variations in firm-level corporate governance practices.

Table 2: Comparison of Annual Average Total Corporate Governance Scores with the Maximum Possible Value

This Table compares the actual score of CG (actual level of compliance) with the Index value of CG (maximum possible level of compliance) based on a one-sample t-test.

Variable	2000	2001	2002	2003	2004
Mean Difference of the Actual CG and the Maximum Possible CG	-55.44	-52.63	-50.50	-46.24	-44.55
T -statistics	-28.59	-25.16	-22.80	-18.59	-17.31
p-value	0.00	0.00	0.00	0.00	0.00
Maximum CG	54	55	60	65	68
Minimum CG	4	3	3	4	4

A detailed analysis of variables under each component was carried out to identify the variables that have contributed towards the increasing trend reported in Table 1 and the areas of non-compliance which have contributed to the significant gap reported in Table 2. The results of this analysis presented in Table 3 reveal the level of compliance with individual variables included under each sub component.

Table 3: Compliance with the Individual Variables of the Corporate Governance Index

This Table shows the best practice requirements which most companies have complied with (denoted as high level of compliance) and the best practice requirements which most companies have not complied with (denoted as low level of compliance). The level of compliance with individual variables is presented under each sub component of the Index.

Sub Component	Level of Compliance	
	High	Low
Board Effectiveness	• Clearly defined role for the board inclusive of both strategy formulation and monitoring • Introduction of non-executive directors to the board • Separation of rules of Chairman and CEO • Board diligence (attendance to board and board committee meetings, and number of directorships held outside the group)	• Independence of non-executive directors • Appointment of a nomination committee to oversee board appointments including succession planning and performance evaluation of directors • Professional development of directors.
Risk Management Processes and Internal Controls	• Establishment of an internal financial control system and internal audit	• Emphasis on risk management processes and other types of controls
Audit Committee Characteristics	• Appointment of an audit committee with a clearly defined role, authority and responsibilities of the committee • Membership of the committee have the necessary financial expertise	• Independence of membership
Directors' Remuneration		• Appointment of a remuneration committee to oversee the determination of executive directors' remuneration • Independence of membership

As revealed in Table 3, most companies have complied with the best practices on role, composition and diligence of the board; establishment of internal financial controls and internal audit; and appointment of an audit committee with a clearly defined role and members with necessary financial expertise. These variables have contributed towards the increasing trend in corporate governance scores reported in Table 1. On the other hand, most companies have not complied with the appointment of board committees on nomination and remuneration of directors, independence of non-executive directors, professional development of directors, and incorporation of risk management processes within internal controls. These variables have contributed towards the significant gap between the maximum possible CG and the actual CG reported in Table 2. In light of these findings, the significant features of corporate governance practices of Sri Lankan companies are analysed in the following section.

Significant Features of Corporate Governance Practices

The findings of the study presented and described in the preceding section indicate that significant features of corporate governance practices of Sri Lankan listed companies can be differentiated as positive and negative features. The 'positive features' represent the items of corporate governance best practices which the majority of these companies have either complied with or shown an increasing tendency to comply with. These features include the board of directors having a clear and specific role to play covering both strategy formulation and monitoring functions, a board comprising both executive and non-executive directors, separation of roles of Chairman and CEO, higher board attention to company activities, the maintenance of a proper system of internal financial controls and internal audit, and appointment of an audit committee to oversee financial reporting and audit process. On the other hand, the 'negative features' represent those aspects of corporate governance best practices, which the majority of sample companies show a low level of compliance with throughout the sample period. These features include lack of independent non-executive directors, absence of board committees on nomination and remuneration to oversee the appointment of directors and determination of directors' remuneration respectively, and inadequate attention to the professional development of directors.

(a) Positive Features: The positive features of corporate governance practices of Sri Lankan companies revolve around the role of the board and mechanisms required for the effective discharge of its role, internal controls and audit committees. A close review of these features would indicate how they would contribute to the effectiveness of the corporate governance structure of Sri Lankan companies.

Since the board plays a pivotal role in corporate governance, its role underlies effective corporate governance. The study finds that the directors of Sri Lankan companies fulfil both conformance (accountability and monitoring) and performance (strategy formulation and decision-making) roles expected from the directors of a company (Tricker, 1994). Under the monitoring role, the board ensures that the management runs the company in the best interests of shareholders and other stakeholders of the company and in accordance with the law. On the other hand, as a performance enhancer, the board's role is to act with the top management in improving the viability and value of a company over time.

On the other hand, the measures taken to increase the board's effectiveness determine whether the directors effectively discharge their principal responsibilities (roles) in relation to the stewardship of companies (Labelle, 2002). Hence, the presence of positive features in relation to mechanisms for improving board effectiveness is an encouraging feature of corporate governance in Sri Lankan companies. These features are a single-tiered board comprising executive and non-executive directors, chairman/CEO, separation of roles, duality and higher board diligence. They contribute to the effective discharge of performance and conformance roles of directors. The improvement shown by Sri Lankan companies in appointing non-executive directors to the board and maintaining a proper balance of executive and non-executive directors particularly could yield several benefits for these companies. Although both executive and non-executive directors have the same general legal duties towards the company, non-executive directors can bring fresh perspectives and contribute more objectively to supporting as well as constructively challenging and monitoring the management team as they are not involved in the day-to-day management of the company (Higgs Report, 2003). Further, the inclusion of non-executive directors in the board avoids concentration of power and information in one or a few individuals and lowers the possibility of top management colluding and expropriating shareholders (Fama, 1980). This has been further strengthened by the separation of the roles of Chairman and CEO.

On the other hand, the establishment of effective internal financial controls (including an internal audit) and the appointment of an audit committee for the oversight of financial reporting and audit in Sri Lankan companies contribute to improving the accountability of the board to the shareholders and other stakeholders. This is one of the main responsibilities of the board. These improvements in relation to internal controls and audit committees also contribute to enhancing the quality of financial reporting and thereby reducing the information asymmetry that could arise between shareholders and managers owing to the separation of ownership and control in corporate entities. Cohen, Krishnamurthy and Wright (2004) suggest a corporate governance 'mosaic' (i.e. interactions among actors and institutions that affect corporate governance) and its impact on the quality of financial reporting. They identify that the interrelations among these actors (i.e. the board, the audit committee, the internal auditor, the external auditor and the management) are crucial to effective corporate governance and thereby to achieving high quality financial reporting.

A system of internal controls is not solely concerned with accountability, it is an integral part of the management process; ineffective controls result in an ineffective management process. Since effective internal control is linked inextricably to the efficient management of an organisation and improved corporate governance, it is addressed as a key issue in almost all corporate governance codes. The maintenance of a proper system of internal financial controls and an internal audit by Sri Lankan companies shows that the directors have recognised the importance of internal controls in effective corporate governance. It is the responsibility of the board of directors to set appropriate policies on internal control and review the effectiveness of the system of internal controls regularly to ensure that it is functioning effectively (Turnbull Report, 1999). Further, the improvements in internal controls in Sri Lankan companies are closely linked to the developments that had taken place in relation to their audit committees and *vice versa*.

The codes of best practice usually advocate appointing board committees on audit, remuneration and nomination, as subsets of the overall board. These committees allow non-executive directors to improve their monitoring over areas such as financial reporting, internal control, remuneration, appointment and removal of directors, which are susceptible to conflicts of interests between management and shareholders. In this respect, an important characteristic of the corporate governance structure of Sri Lankan companies is the appointment of an audit committee, which allows non-executive directors to deliberate and make recommendations in relation to financial reporting and internal control and potential areas of conflict of interests between the management and the shareholders. Prior studies (e.g. Wright, 1996; Cohen et al., 2004) show that the audit committee is crucial in resolving auditor-management disagreements on significant financial reporting issues, an aspect of critical importance in supporting and enhancing auditor independence. The prominence of audit committees in Sri Lankan companies is similar to the situation prevalent in other Asian Countries (OECD White Paper on Corporate Governance, 2003) and it may also be associated with the dominance of accounting professionals on the boards of these companies and the developed accounting profession in Sri Lanka (Senaratne, 2007). Further, the clearly defined authority and responsibilities of audit committees of most of these companies indicate that they oversee a wide range of issues that includes oversight of financial reporting, review of internal controls, and monitoring the activities of internal and external auditors as expected in the best practices. The Smith Report (2003) identifies that the primary role of audit committees is to ensure the integrity of financial reporting and the audit process by ensuring that the external auditor is independent and objective and does a thorough job, and by fostering a culture and an expectation of effective oversight. Hence, the audit committee is a significant feature of the corporate governance structure of Sri Lankan companies.

(b) Negative Features: The negative features associated with the corporate governance practices of Sri Lankan companies are related to board effectiveness (associated with independence of non-executive directors, appointment procedure of directors and professional development of directors), risk management and non-financial controls and determination of directors' remuneration. These features reduce the independence and professional character of the board and inhibits realising the full benefits of the positive features of corporate governance practices in Sri Lankan companies. Hence, it is useful to assess the implications of these negative features.

In most Sri Lankan companies, the non-executive directors though independent of management, have business and other relationships that impair their independence. Most of them either represent interests of a substantial shareholder or hold cross directorships. They hold cross directorships either with other directors of the company or in companies with which the company has business dealings. This presence of related non-executive directors (also referred as 'grey directors') prevents these companies from realising the full benefits of appointing non-executive directors to the board (who are expected to play a larger role in monitoring management) and also affects the effective functioning of board committees (formal mechanisms through which directors are expected to supervise management) as indicated in the studies of Menon and Williams (1994), Collier and Gregory (1999), and Mak (2001) and Al-Mudhaki and Joshi (2003). The independence of board committees is a key factor in its ability to confront management and work effectively with the auditor, which in turn is largely dependent on the attitude and independence of the board. This shows that most Sri Lankan companies have 'managing boards' which are constituted of executive directors and their close friends and associates in contrast to 'governing boards' consisting of many independent directors and a few executive directors. The dominance of related directors in the board reduces professionalism in decision-making and allows little opportunity for the introduction of new ideas and thinking into the decision making process. In such companies the directors are more focused on their welfare rather than focusing on the interests of the larger group of stakeholders. However, this will not have serious implications for directors, as their existence is not threatened within the managing board.

On the other hand, the absence of a nomination committee in most Sri Lankan companies precludes having a formal and transparent procedure for the appointment of new directors to the board. This has also led to Sri Lankan companies paying inadequate attention to succession planning and performance evaluation of directors, which are usually associated with a formal appointment process of directors. The absence of a nomination committee for the oversight of board appointments could be associated with the presence of a controlling shareholder in most Sri Lankan companies, who would strongly influence board appointments as found in the study by Senaratne and Gunaratne (2007b). The OECD White Paper (2003) shows that owing to the high ownership concentration in Asia, imbalance between the board and the management typically involves a relatively permissive board, since in practice the management and the board are appointed by and answerable to a controlling shareholder group. Further, Vafeas (1999) finds an inverse relationship between the inside ownership and appointment of a nomination committee in USA companies. Therefore, the ability of a nomination committee to improve the quality of the board hangs on the influence of the controlling shareholder.

Further, insufficient attention paid to the conduct of professional development programmes for directors does not give them an opportunity to update their knowledge and skills required to fulfil their roles effectively. Most of these companies are of the view that the directors do not need to undergo professional development programmes as they are experts in different fields and sufficiently experienced. This superiority attached to directors could be associated with several cultural and social dimensions of the country as found by Senaratne and Gunaratne (2008).

Although there is heavy emphasis on internal financial controls in Sri Lankan companies, still a considerable number have not paid adequate attention to other types of controls including risk management, which is a key feature in international developments in corporate governance best practices. The scope of codes on best practices such as Hampel (1998), Turnbull (1999) and the UK Combined Code (2003), which were developed subsequent to the Cadbury Code focusing on all types of controls including financial, operational and compliance controls, and risk management. Spira and Page (2003) cite the publication of the Turnbull Report as a radical redefinition of the nature of internal control as a feature of corporate governance where risks are managed within the corporate governance framework through accountability mechanisms such as financial reporting, internal controls and internal audit. This highlights the need to strengthen corporate governance practices of Sri Lankan companies in relation to risk management and non-financial internal controls over and above internal financial controls.

Only a few Sri Lankan companies have a remuneration committee to oversee the determination of directors' remuneration. This indicates that most companies do not have a clearly defined procedure for the determination of directors' remuneration, which is a violation of openness, the overriding principle in relation to board remuneration. The Cadbury Report (1992) states that the shareholders of a company are entitled to receive a full and clear statement of directors' present and future benefits, and of how their remuneration has been determined. Although not specifically established, the lack of transparency in the determination of directors' remuneration could also be associated with the presence of a controlling shareholder in Sri Lankan companies.

The above deliberations on the significant features of corporate governance practices in Sri Lankan listed companies show that to a certain extent they have embraced international corporate governance best practices that have been developed in line with the Anglo-Saxon Model of Corporate Governance. Further, this discussion reveals the existence of a few underlying factors influencing the level of compliance of Sri Lankan companies with the best practices and thereby contributing to the existence of both positive and negative features in governance practices of Sri Lankan corporate entities. Hence, it is necessary to assess in detail the issues associated with the implementation of internationally accepted best practices in the Sri Lankan context.

Associated Issues of Corporate Governance Practices

The discussion of salient features of corporate governance practices in Sri Lankan companies identified in the preceding section indicates that there is a general tendency among these companies to adopt international best practices. However, these companies have not sufficiently complied with some of the best practices.

This low or non-compliance can be considered as the issues associated with the implementation of internationally accepted best practices in the Sri Lankan context and it seems that most of these issues are interrelated.

The existence of issues associated with the implementation of corporate governance best practices developed largely in line with Anglo-Saxon Principles is a common phenomenon in many emerging markets as revealed in the studies of Krambia-Kapardis and Psaros (2006) in Cyprus, Rwegasira (2000) in African countries and Haniffa and Hudaib (2006) in Malaysia. These issues highlight that the corporate governance is to a certain extent context-specific as discussed in the 'open-system approach' to corporate governance. This approach considers that organizational features are dependent on the diversity, fluctuations and uncertainties of their environment and rejects universalistic 'context-free' propositions advocated in the agency theory and its variants (Aguilera and Jackson, 2003). Hence, it emphasizes the importance of examining corporate governance practices within a holistic context, rather than as a single factor acting in isolation as usually advocated in the universalistic perspective on corporate governance adopted in the agency theory. In this context, the study closely reviews associated issues of corporate governance practices in Sri Lankan companies.

As discussed in the preceding section, the negative features of corporate governance practices in Sri Lankan companies to a large extent stem from the presence of a controlling shareholder in these companies. Senaratne and Gunaratne (2007b) find several salient characteristics of the corporate ownership structure of Sri Lankan companies, which would have serious implications for the structure and practice of corporate governance. These salient characteristics are the concentrated ownership structure with the presence of a controlling shareholder; the controlling shareholder is usually another corporate entity and in most cases it is the parent company or group companies; wide prevalence of family ownership as the ultimate owners; extensive use of a pyramid ownership structure, cross-holdings and participation in management by controlling shareholders to enhance corporate control whereby controlling rights are achieved in excess of cash flow rights; and the absence of a large community of arms-length institutional shareholders. This study finds that the controlling shareholder has a strong impact on the corporate governance structure of Sri Lankan companies particularly on the appointment, succession planning and performance evaluation of directors and the independence of non-executive directors as reported in the studies of Vafeas (1999) and Cotter and Silvester (2003). This is mainly because of the controlling shareholder's power to install whomever he/she wishes as managers. Hence, this could pose serious corporate governance problems especially in relation to the protection of minority shareholders' rights as the agency relationship in these companies lies mainly between the minority shareholders and the controlling shareholders (Claessens & Fan, 2002; Chong & Lopez-de-Silanes, 2007). Thus, the successful implementation of corporate governance best practices in Sri Lankan listed companies would depend very much on the level of influence of the controlling shareholders and their ownership patterns.

However, this is a common phenomenon in the Asian Region as found in the study of Claessens, Djankov and Lang (2000). The OECD White Paper (2003) reveals that the concept of independent non-executive directors is not a real life experience in Asia unlike in other regions. It cites that this issue mainly arises from the high ownership concentration in the Asian Region listed companies where the controlling shareholders usually select the entire board of directors. Hence, the core concern of corporate governance codes of Asian countries including Sri Lanka should be the protection of minority shareholders from the controlling shareholders' opportunism. This shows that while lessons can be learnt from the models of corporate governance in the developed economics, these models should be adapted and tailored to the circumstances peculiar to a developing country like Sri Lanka.

Although the Sri Lankan companies show an inclination towards the Anglo-Saxon Model of Corporate Governance, the presence of controlling shareholders and their strong influence on corporate governance practices raises the question how appropriate is this model for Sri Lanka, as it presumes that the ownership of listed companies is widely held (Senaratne and Gunaratne, 2008). This high ownership concentration in Sri Lankan companies has also contributed towards the low level of liquidity in the capital market and the absence of an active takeover market, which is usually considered as an effective corporate governance mechanism. This shows that the essential characterises for the successful implementation of the Anglo-Saxon Model are lacking in Sri Lanka. These characterises are ownership dispersion, presence of institutional shareholders, the central role the capital market plays in the economy and the availability of a takeover market. In contrast, the existing governance structure of Sri Lankan companies dominated by the controlling shareholders shows some similarity to inside systems of relationship-based corporate governance prevalent in Continental European and Asian countries, where the ownership concentration is a typical characteristic. This implies that a hybrid system of corporate governance (which has characteristics of both the Anglo-Saxon Model and inside systems of corporate governance prevalent in Continental European and Asian countries) is in operation in Sri Lanka although the corporate governance best practices have been introduced in terms of the Anglo-Saxon Model. This implies that Sri Lanka should adopt a broader outlook on corporate governance reforms rather than limiting itself to the traditional dichotomy between market and insider systems of corporate governance. Some researchers even question the validity of this dichotomy between market and non-market models. Letza, Sun and Kirkbride (2004) argue that this dichotomy is no longer valid in the modern business environment as these models have been built on arguments and ideals based on traditional assumptions and theories that were generated or constructed in centuries-old societal contexts. Further, the Anglo-Saxon Model has not gradually evolved in Sri Lanka as had happened in Anglo-American countries to their economic, social and political environment (Senaratne and Gunaratne, 2008). This too could have been a contributory factor towards the low compliances with best practices identified in the study. Hence, a broader framework of corporate governance is required in emerging markets. In their study on corporate governance in India, Gollakota and Gupta (2006) suggests that a framework on corporate governance should be developed by emerging markets incorporating market and situational forces that have strong influences on governance.

Another important issue associated with the governance practices of Sri Lankan companies is the inadequacies in the Sri Lankan legal structure for the protection of investors' rights. Although Sri Lankan regulators have shown a marked improvement in developing a Code of Best Practice for corporate entities, Sri Lanka's Company Law was not updated for nearly 25 years and it is not clear whether laws against the inside trading are applied sufficiently. Further, the ICASL Code of Best Practice was not incorporated into the Listing Rules of the CSE during the period under consideration of the study. This indicates that Sri Lankan corporate governance practices lack 'form convergence', which predicts a convergence of legal rules and institutions with international best practices. These limitations in the legal system too could have implications on the governance structure and system of Sri Lankan companies. La Porta, Lopez-de-Silanes, Shleifer and Vishny (1998) hypothesise that the legal system is a fundamentally important corporate governance mechanism. In particular, they argue that the extent to which a country's laws protect investor rights and the extent to which those laws are enforced are the most basic determinants of the ways in which corporate finance and corporate governance evolve in that country. They show that a main cause for the concentrated ownership of companies is the limitations of the legal structure of the country. Prior studies too discuss the intimate relationship between the ownership structure and the legal structure. Denis and McConnel (2003) point out that only ownership concentration can overcome the lack of protection in countries with weak legal protection for investors. Shleifer and Vishny (1997) too assert that good corporate governance systems are rooted in an appropriate combination of legal protection of investors and some form of concentrated ownership. Hence, in the countries without a strong protection for investor rights, the concentrated ownership is a necessary condition as it gives power to the shareholders to monitor and control the managers. Therefore, the concentrated ownership structure in Sri Lankan listed companies to a certain extent depends on the lack of an appropriate legal structure in the country for the protection of shareholders' rights and this in turn influences the governance practices of these companies.

The need to enhance the protection of minority shareholders and improve corporate governance is also closely linked to the political governance of the country. This is because of the close interaction between the institutions of political governance with those of corporate governance. Further, political governance can bring a greater discipline for better corporate governance by nurturing an appropriate external environment in which these entities operate. However, the quality of political governance is always questionable in Sri Lanka as revealed by the surveys of various international agencies. Transparency International Corruption Perception Index (which measures the degree to which corruption is perceived to exist among public officials and politicians by business people, academics and risk analysis) ranks Sri Lanka at 66th place among 133 countries considered for the analysis in 2003. This situation has further deteriorated over the years. Hence, it is unlikely that the political governance of Sri Lanka would contribute positively towards the improvement in corporate governance.

The above discussion shows that several issues are associated with the implementation of the international best practices on corporate governance developed in line with the Anglo-Saxon Model in the Sri Lankan context. These issues have much deeper roots involving economic, political and legal factors. Hence, they should be deliberated and closely reviewed at future corporate governance pursuits of the country. Otherwise, the desired results of corporate governance reforms will not be realised by the country.

Conclusion

The examination of the corporate governance practices of Sri Lankan listed companies reveals that both positive and negative features are associated with them. The positive features indicate the upsurge in the development of corporate governance practices of Sri Lanka companies with the internationally accepted best practices developed in line with the Anglo-Saxon Model. However, the existence of negative features acts as a hindrance to receiving the full benefit of the positive features. This examination also reveals that most of these negative features are associated with the presence of a controlling shareholder in the majority of Sri Lankan listed companies. This raises concerns as to the protection of minority rights in these companies, which is a major corporate governance problem in most other emerging markets in the world.

The concentration of corporate power with a controlling shareholder could also have a negative impact on resource allocation in the country and thereby on the economic development. Hence, understanding corporate governance practices of Sri Lankan companies also requires an examination of the determinants of ownership structures and corporate governance practices of these entities as well as of the other emerging markets particularly in the Asian Region. The concentrated ownership structure also highlights that all conditions necessary for the successful implementation are not present in the Sri Lankan context. A main reason for the non-existence of necessary conditions is that Sri Lanka has inherited this model as a legacy of British colonial rule, but not as a result of a gradual evolutionary process as had happened in developed countries. Further, the development of corporate governance practices of Sri Lankan firms should be investigated from the broad context of the overall development of the financial system of the country and interaction between corporate and political governance of the country. These aspects require further investigation.

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