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## Corporate governance in Sri Lanka: the status quo

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### Abstract

This paper examines the existing corporate governance environment, practices, and institutional framework in Sri Lanka and evaluates their effectiveness to identify current issues and challenges. Sri Lanka is an emerging and rapidly growing market economy in South Asia with a liberalised economic and trade policies associated with FDI, international trade, and export-led development policies. Sri Lanka's corporate governance (CG) systems and practices have been largely influenced by both colonial economic policies and post-independence govt policies. Its CG practices consists of promoting dispersed ownerships, increasing size of a board and decreasing directorship per director, greater involvement of internationally recognized few audit firms in accounting and auditing functions, professional orientations of company secretariat services. The provisions of Companies Act, the role of Securities and Exchange Commission, professional accounting and auditing institutions, Central Bank of Sri Lanka and the country's regularity environment play a significant role in the implementation of CG systems in the country. With the rapid expansion of the corporate sector in recent years, there is need for improving the current regularity mechanism in the country. The paper addresses the issue of whether the current governance mechanisms in Sri Lanka are adequate to respond to the needs of the fast changing business environment in Sri Lanka and to face the challenges posed by the changing domestic and global corporate environment.

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## Corporate Governance in Sri Lanka: the Status Quo

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### *Abstract*

*This paper examines the existing corporate governance environment, practices, and institutional framework in Sri Lanka and evaluates their effectiveness to identify current issues and challenges. Sri Lanka is an emerging and rapidly growing market economy in South Asia with a liberalised economic and trade policies associated with FDI, international trade, and export-led development policies. Sri Lanka's corporate governance (CG) systems and practices have been largely influenced by both colonial economic policies and post-independence govt policies. Its CG practices consists of promoting dispersed ownerships, increasing size of a board and decreasing directorship per director, greater involvement of internationally recognized few audit firms in accounting and auditing functions, professional orientations of company secretariat services. The provisions of Companies Act, the role of Securities and Exchange Commission, professional accounting and auditing institutions, Central Bank of Sri Lanka and the country's regularity environment play a significant role in the implementation of CG systems in the country. With the rapid expansion of the corporate sector in recent years, there is need for improving the current regularity mechanism in the country. The paper addresses the issue of whether the current governance mechanisms in Sri Lanka are adequate to respond to the needs of the fast changing business environment in Sri Lanka and to face the challenges posed by the changing domestic and global corporate environment.*

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## **Corporate Governance in Sri Lanka: the status Quo**

### **1. Introduction**

The primary objective of this paper is to present an overview of the corporate governance mechanism in Sri Lanka and to discuss its recent developments together with the issues and challenges that the policy makers are confronted with in improving the current system. The paper is organised as follows. Section 2 provides a historical background of the CG practices in Sri Lanka; section 3 highlights recent trends; section 4 outlines the legal and regulatory framework; section 5 evaluates the effectiveness of the CG practises; section 6 presents the issues and challenges and; section 7 concludes the paper.

### **2. Historical background**

Sri Lanka, which was known as Ceylon, is an emerging economy in South Asia with a relatively small population of 20 million and a fast developing economy in the region. Since the end of prolong civil war in 2009, Sri Lanka's economy has been growing at an average growth rate of 5.3%. Its economy has been very resilient to both internal and external shocks over the last two decades. Socially, Sri Lanka's has achieved human development outcomes more consistent with those of high income countries (The World Bank, 2010). In recent years, the country has implemented many economic reforms, most prominently in trade, taxation, privatization, and enhancing the flexibility of the labour market. With the steady expansion of business sector in Sri Lanka, there has been increasing interest in corporate governance practice in Sri Lanka.

There has been lack of studies examining corporate governance experiences in emerging countries (Shleifer and Vishny, 1997; Monks and Minow, 2004). Monks and Minow (2004) point out the significance of the emerging market economies in an inter-dependent world and in the context of the flow of international capital across the borders. However, Herrigel (2006) notes that the history of corporate governance arrangements, which has been understood as the constitutive processes shaping the relationship between ownership and management of enterprises, is a relatively new field of inquiry for business historians.

Sri Lanka was under number of colonial masters since 1505 until it gained political independence in 1948 from the British rule which was the longest period in its colonial rule (1815-1948). Under the colonial rule, some form of formation of the capital market development was initiated. Acemoglu, Johnson and Robinson (2001) argue that the colonial economic policy had two strategic approaches in dealing with the colonies. Which policy was to be suitable for a particular colony was decided by the mortality rate of the colonisers, traders and missionaries. Accordingly, if the mortality rate among them was low, then they moved to a colony and decided to settle down. Subsequently, they developed the property rights as they enjoyed in their parent countries, which constitutes the common law by British and civil law by French. Australia, New Zealand, and the US were chosen by the British colonisers as conducive for settlement as the

colonizers experienced less mortality. Therefore, the systems of law prevailed in Britain was developed in these countries as well.

Among the colonies, which had higher mortality rate but with natural endowments such as minerals, fertile land and weather for crops, such endowed colonies were used for the development of the parent country by exploiting to the maximum (Acemoglu and Johnson, 2005). Beck, Demirgüç-Kunt and Levine (2003) argue that in an extractive environment, colonisers did not construct institutions that favour the development of competitive markets as the colonizers believed that the competitive markets could threaten the position of the extraction. Sri Lanka and India were attractive for geo-political strategic reasons. British naval forces could control the entire Indian Ocean with the natural harbours. As a result, they developed the common law but not to the full extent required to development of a capital market as in Australia and New Zealand (Acemoglu, Johnson and Robinson, 2001). Morgan (1958) argues that Sri Lanka was a classic example for extraction of its resources with the least development of capital market and its constitutive processes such as the property law and civil law. Nevertheless, the following milestones are important in the development of corporate governance practices in Sri Lanka.

#### ***Introduction of Property Right Law in 1832***

In the nineteenth century, the government took title to wide areas of uncultivated hill land in Central Ceylon and sold them to British planters. The Waste Land Act of 1832 was implemented by the colonial government and accordingly Ceylonese who could not claim for land by documentary evidence lost the possession of their lands. These lands were sold to British planters and to civil servants subsequently at cheaper prices (Ceylon Banking Commission, 1934). Although countries differ in the extent to which their legal system define and protect property right, this act provided the legal basis for an individual or business to hold a legal title for a resource that it owns.

#### ***Facilitating Capital Formation and the Establishment of Colombo Share Brokers Association in 1896***

In order to find large scale capital for the plantation industry, the Colombo Share Brokers Association was established in 1896 (CSE, 2004). Plantation sector companies were the most significant in the corporate sector in the economy till mid 1970s in terms of creating employment opportunities and earning vital foreign exchange earnings (Commission of Inquiry on Agency Houses and Brokering Firms, 1975; Moore, 1997).

#### ***Substandard Growth in Capital market in Sri Lankan until 1990s***

There has been substandard growth in the capital market until 1990s mainly due to colonial economic policies and repeated turnaround economic policies of post independent governments. Lakshman (1985) argues that the colonial government did not produce the necessary conditions for an organic development of capitalism on a wide front as the surpluses generated in the plantation sector was sent to Great Britain leaving very little for further accumulation in the domestic economy. Moore (1997) reports that some British firms engaged in

tea auctions, both as buyers and sellers, undercut the prices and controlled almost everything from plantation to retail trade. This has happened not only in Sri Lanka but also in India as British planters own the industry (Tharian, 1984). As such, Tharian (1984) noted that the British planters and the owners of the plantation companies repatriated under invoiced profits. Researchers point out that even after post independent era beginning in 1948 until 1970s, several factors inhibited the development of a conducive environment for the growth of the corporate sector (Lakshman, 1985; Oberst, 1985; Snodgrass, 1998). First, the assistance programs of the World Bank and the International Monetary Fund had no serious involvement to develop the capital market (Lakshman, 1985). Second factor is the 'Westernized elite's continued domination of power' (Oberst, 1985:760) and acceptance of economic models of the developed countries by the policy planners either due to the privileges they enjoyed such as scholarships and other key posts in some government organisations (Goonetilake, 1975).

Apart from the above factors, Sri Lanka has experienced 'repeated turnarounds in economic policy' (Snodgrass, 1998:1). Governments in the 1950s, 1960s and 1970s spent large sums of money on social welfare programs and in state economic activities (Blackton, 1983). La Porta, De-Silanes and Shleifer (1999) argue that in heterogeneous societies such as in Sri Lanka, governments are compelled to intervene in economic activities in order to pacify the diverse interests of a heterogeneous society. The inability of the country to make a coherent economic policy prescription conducive to economic growth and development was caused by different political ideologies of each government which came to power unseating the incumbent government in each general election since its independence in 1948 (Snodgrass, 1998). In this sense, Nithiyandam (2000, P. 284) notes that Sri Lanka was an 'Economic Laboratory'.

### ***Growth of capital market after 1990s***

The slow growth scenario noted above changed dramatically since mid 1980s. Moore (1997) points out that many changes in the international environment such as the liberalisation of economies world wide and competition for foreign equity flows and FDI among developing countries led to a common understanding among mainstream national political parties in the country with regard to the need of having a coherent economic policies based on market principles. Moore (1997) notes that the Colombo Share Market was also successful in attracting investment as he observed that, for the first time ever, the stock market became the largest single source of new capital for the private sector' in 1994 (Moore, 1997:360).

## **3. Recent Trends**

### ***Increased recognition and involvement in capital market and promoting dispersed ownership.***

The number of listed firms has grown from 141 in 1977 to 250 in 2011, showing an increase of 77 per cent in this period. This shows that many companies which have been registered prior to 1977 have sought equity capital. In 2002, the Government of Sri Lanka gave the non-nationals the permission to buy shares to the full value of issued capital of a listed company either through approved country funds, regional funds, and corporate bodies or as individuals subject to some exclusions and limitations. Due to these new measures taken, many of the established firms seized the opportunities to get listed and also were successful in

mobilising equity capital (Samarakoon, 1999). Table 1 shows that there is a dispersed ownership as well as large ownership of shares as in the case of other markets in both developed and emerging countries (La Porta, De-Silanes and Shleifer, 1999). For example, a large number of shareholders holds less than 1,000 shares by each (86.7 percent of total shareholders) and a few numbers of large shareholders.

Dispersed share ownership results in poor involvement in corporate governance as found in many developed capital markets (Stratling, 2003; Monks and Minow, 2004). Due to dispersion of risks across a section of stocks (Fama and Jensen, 1983) and due to various commitments, individual investors are not keen in corporate governance as witnessed by poor attendance for annual general meetings in the capital markets (Davies, 2003). On the other hand, large scale ownership has resulted in reducing agency conflicts and inevitably neglecting the interest of the minor shareholders (La Porta, De-Silanes and Shleifer, 1999; Claessens and Pan, 2002).

**Table 1**  
**Size distribution of Shareholdings among the Shareholders (174 companies)**

<i>Number of shares owned</i>	<i>Number of shareholders</i>	Percentage of total*
Less than 1,000	524,530	86.7
1,001 – 5,000	53,521	8.8
5,001 – 10,000	13,042	2.2
10,001 – 50,000	10,021	1.7
50,001 – 1,000,000	3,183	0.5
Over 1 million	589	0.1
<b>Total</b>	<b>604,886</b>	<b>100</b>

*Source:* Survey data compiled using Handbook of Listed Companies, Colombo Stock Exchange

### ***Increasing size of a Board and Decreasing Directorship per Director***

There are several noteworthy features in relation to the directorships of listed companies, as shown in Table 2. First, the average size of a board or the number of directorships in a quoted company has increased from 3.8 in 1951 to 5.4 in 1971 and 7.2 in 2004. Second, the average number of directorships per director has gradually decreased since 1951 to 2004 from 2.8 to 1.5 respectively. Number of directors holding only one directorship also has increased from 56 in 1951 to 76 in 2004. Number of directors who hold multiple numbers of directorships (more than 10 directorships) has been gradually decreasing from 14 in 1951 to 8 in 2004. Cosh and Hughes (1987) find similar characteristics in relation to the directorship in large UK and US public companies.

**Table 2**  
**Distribution of Directorships of Quoted Companies, 1951, 1971, 1988 and 2004**

	<i>1951</i>	<i>1971</i>	<i>1988</i>	2004
Number of quoted companies	189	153	176	243
Total number of company directorships	718	824	1256	1766
Average number of directorships per company	3.8	5.4	7.1	7.2
Average number of directorships per director	2.8	2.2	1.6	1.5
Percent of directors holding only 1 directorship	55	67	75	76
Number of directors holding 10 or more directorships	14	12	4	8
Percent of directorships held by persons holding 10 or more	22	17	4	.06

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directorships

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*Source: Compiled data from Moore (1997:353) and Handbook of Listed Companies, CSE.*

***Greater involvement of internationally recognized few large Audit firms***

The financial statements of listed firms are audited by audit firms registered in Sri Lanka. Some of them are the branches of international audit firms. Table 3 shows that 90 percent of companies are audited by three international audit firms namely, KPMG, Ernest and Young, and Price Waterhouse Coopers. However, the lack of the presence of Deloitte Audit firm in Sri Lanka is also evident. The number of companies audited by them in 2004 is 98, 70 and 22 respectively (Table 3). There is also a number of Sri Lankan audit firms among which, three firms (HLB Edirisinghe, Kreston M N S and Ford Rhodes Thornton) performed audit of 17 companies. Small companies in terms of turnover and assets are usually audited by individual audit firms. Some authors argue that when the auditing is done by an international audit firm, better corporate transparency could be expected (Bushman, Piotroski and Smith, 2004).

**Table3**  
**Concentration of Auditing of Corporate Sector**

<i>Name of the audit firm</i>	No of firms
KPMG	98
Ernst and Young	70
PriceWaterhouse Coopers	22
HLB Edirisinghe & Co	7
Kreston M N S & Co	6
Ford Rhodes Thornton	4
Each auditor having three firms	12
Each auditor having two firms	8
Single auditors each having one firm	12
Total number of firms	239

*Source: Handbook of Listed Companies 2004, Colombo Stock Exchange*

### ***Professional Orientation of Company Secretariat services***

A governance role that is changing in significant ways is that of the company secretary (Style, 2001). Although the role is less important in smaller companies, it is becoming more important in larger organisations where the company secretary is increasingly charged with ensuring good governance and compliance (Nicholson and Kiel (2004). They, however, note that the significance of a company's secretary's role in CG has not been researched adequately. Similarly, the issue of whether the secretariat function is needed by the small firms has not been empirically examined. Company Acts in the UK (sections 272 to 279 in 2006 Companies Act) and Sri Lanka (sections 221 and 222 in Companies Act, No. 7 of 2007) indicate various aspects of the company secretary such as the appointment, duties and qualifications.

There are two types of company secretaries in Sri Lankan companies.

- (1) Legal and accountancy firms functioning as company secretaries. They provide other services such as legal consultancy and accounting
- (2) Individual secretaries mainly consist of lawyers and chartered accountants.

Among the legal and accountancy firms which function as company secretaries, one firm serves 16 companies on average, while the majority of the companies in the corporate sector are served by individual secretaries (number of firms 52) (see Table- 4). Company secretarial function is considered as a vital element in linking the shareholders with the management and the board of a company (Companies Act, 2006). Therefore, it is required to pay attention to the argument of Nicholson and Kiel (2004) who point out the lack of studies on this vital function and the need for research.

**Table 4**  
**Concentration of Corporate Secretarial Function**

<i>Number of listed firms</i>	<i>No of secretarial firms</i>	<i>Number of individual secretaries</i>	<i>Total</i>
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1 firm	16	52	68
2 firms	6	5	11
3 firms	8	0	8
4 firms	4	0	4
5 – 10 firms	6	0	6
11 – 15 firms	4	0	4
16 – 20 firms	1	0	1
<b>Total</b>	<b>45</b>	<b>57</b>	<b>102</b>

Source: *Handbook of Listed Companies 2004, Colombo Stock Exchange*

#### 4. Legal and regulatory framework

##### *Companies Act, No. 7 of 2007*

The Companies Act No. 7 of 2007 is the most significant regulation governing companies in Sri Lanka. This Act replaces the existing Companies Act No. 17 of 1982 which was based on the English Companies Act of 1948. The new Act was necessary to respond to the significant increase in commercial and economic activities in the country and its capital and financial markets in 1980s and 1990s. The new Act moved away from traditional method of adopting UK laws and introduced features of company law in Australia, Canada and New Zealand.

The new Company Act protects the interests of the shareholders and the other stakeholders including directors and managers in many ways. Shareholders have wider powers which they did not have in the 1982 Company Act. Shareholders and co-directors can sue the directors if they fail to exercise due care and diligence in business judgement. However, general duties of the directors are mentioned in the Companies Act No. 7 of 2007 in Sri Lanka as in the Companies Act of 2006 in the UK (section 171 to 177), which includes serving the company within the powers, promoting the business, and exercising reasonable judgment and care. However, corporations can decide what type of specific tasks the directors have to take in relation to the business activities.

The new Act also gives power to the shareholders and directors to initiate derivative law suit actions (section 234-237). This is a new feature which was not available in the Company Act of 1982. Derivative law suit against the company is a right of the shareholders and the directors in many countries such as the US and the UK. However, according this section, the court has the right to decide to proceed or discontinue the proceedings. In the case of derivative suit actions, the company has to bear the cost of proceeding. At the same time, if the shareholders make false claims and if it is proven by the management in the Commercial Court, they could be made liable and could be prevented attending the subsequent shareholders' meetings too.

Another significant development in the new Act is that the minority shareholders are given the right to ask the company to buy-back the shares if they think some actions or decisions of the company would damage their interests. Major transactions such as amalgamation with another company, reduction of share capital which could affect the debt equity balance, change of the name of the company and status of the company are such situations (section 92(1) of the Companies Act of 2007). In such situations, the company has the obligation to meet certain

conditions such as decisions on a fair and reasonable price and giving time to express objections by any disaffected shareholders (section 95 of the Companies Act of 2007). However, the Companies Act of 2007 has many checks and balances in the process of the buy-backs such as checking source of financing of buy-backs. According to the section 99, these actions should not contravene the rights of the shareholders.

Directors of public companies are required to meet several criteria before they are appointed to the board of a public company. They include the upper age limits, declaration of the qualifications, declarations of the interest of the directors, re-election, removal, remuneration and restrictions on loans to directors. These criteria could be useful to the shareholders and other stakeholders to see that the directors have behaviour acceptable to them (Eisenhardt, 1989). Accordingly, some of the decisions of the directors such as the amalgamation, winding up and compromises with creditors are required to obtain special approval of the shareholders at an extraordinary shareholders' meeting. However, the Act provides with directors the right to take indemnity and insurance cover. This shows evidence to suggest that the liability of directors is minimised in Sri Lanka too as found in many other countries by Cheffins and Black (2006).

Legal provisions relating to insolvency laws in the country are an area to be developed further (Batra, 2006). In the new Act, there is special attention for the issues arising from winding up of a company due to bankruptcy (section 270 to 284 of the new Act). For example, in such situations, the Act suggests, the appointment of the liquidator and administrator to protect the interest of all the stakeholders.

#### ***Professionals Accounting and Auditing Institutions and Standards***

Sri Lanka Accounting and Auditing Standards Act No. 15 of 1995 provides for the formulation and statutory recognition of Sri Lanka accounting standards and Sri Lanka auditing standards. A monitoring body (SLAASMB) has been set up under this in order to oversee the implementation of the above standards. Among the corporate governance problems widely discussed in literature are the accounting and auditing frauds, discussed as problems of earnings management (Healy and Wahlen, 1999; Leuz, Nanada and Wysocki, 2003; Davidson, Stewart and Kent, 2005). Setting the accounting and auditing standards, implementation and monitoring of the practice are vital aspects in preventing earnings management. The Institute of Chartered Accountants of Sri Lanka (ICASL) is responsible for the adoption of the accounting and auditing standards. ICASL is a member of the International Accounting Standards Committee (IASC) and the International Standards of International Auditing Practices Committee (IAPC).

#### ***Security and Exchange Commission (SEC)***

While the Companies Act, No. 7 of 2007 provides the regulations necessary for the protection of the interests of the shareholders and other stakeholders including debtors, the SEC (established by the Securities Council Act No. 36 of 1987) has been granted the power to regulate the conduct of the security market in Sri Lanka. The SEC is the sole authority which can issue license to operate a stock exchange, appointment of stock brokers and dealers. In order to regulate the

growing number of institutions such as the Unit Trusts, credit rating agencies and underwriters in the financial industry in Sri Lanka since early 1980s, the Securities Council Act No. 36 of 1987 has been revised in 1991 and replaced in 2003 by the new Securities Council Act, No. 18 of 2003. Objects of the SEC are: (1) the creation and maintenance of a market in which securities can be issued and traded in an orderly manner; (2) protection of the interests of investors; (3) operation of a compensation fund to protect investors from financial loss arising from any licensed stock broker or licensed stock dealer being found of not meeting his contractual obligations; and (4) regulation of the securities market and to ensure that professional standards are maintained in such market. Among the investor protection activities, the SEC ensures the compliance of firms to the regulations and prevention of insider trading activities. Listed companies are also required to submit the annual reports within a six months period of the close of the financial year and SEC pays attention for the disclosure level and the quality of financial and non financial information.

### ***Regulation of Listed Firms in the Financial Sector***

Boards of listed firms in the financial sector (commercial banks, merchant banks, finance companies, leasing companies, insurance companies, and long term credit institutions) come under twin control; that is the Registrar of Companies and the Central Bank of Sri Lanka (CBSL). Registrar of Companies in Sri Lanka has the statutory power of verification of the assets and liabilities of listed firms irrespective of the nature of the business. The Monetary Law Act No. 32 in 2002, Sri Lanka insists that the CBSL has the power to verify the assets and liabilities and general business activities of listed firms in the financial industry. Regulatory framework for the commercial banks are relatively more stricter than the others in the financial industry as the commercial banks are required to comply with some international regulations such as the capital adequacy regulations (Basle Accord) of the International Bank for Settlements. The boards of listed long-term credit institutions in the country (Development Finance Corporation of Ceylon, National Development Bank, Housing Development Corporation of Sri Lanka), come under the respective act of incorporation and some influence from the providers of long term capital such as International Finance Corporation and the Asian Development Bank (World Bank, 2007). However, in the case of these long term credit institutions which were established by the Acts of the Parliament, the ultimate power rests with the parliament. Despite the ownership of shareholders both public and institutional, they have no special power to control or to appoint the boards for these institutions. This is a special situation in relation to the shareholder interests (World Bank, 2007).

### ***Finance Companies Act of 1998***

Among other public quoted companies in the financial industry, finance companies, insurance companies, leasing companies, mutual funds and unit trusts play a significant role in the economy (Central Bank of Sri Lanka, 2006). Finance companies are required to get registered under the Finance Companies Act, No 78 of 1988. Before 1988, finance companies were regulated under the Finance Companies Act No 27 of 1979, which was insufficient to effectively supervise and regulate finance companies' (Central Bank of Sri Lanka, 2004:25). The

boards of many of the failed finance companies were responsible for the mismanagement of portfolio, corruption and lack of skills, which resulted in huge losses for the depositors and the tax payers (Central Bank of Sri Lanka, 2004). Of the 72 finance companies, which were operating before the enactment of the Finance Companies Act in 1988, only 25 could be able to register under the new Act (Central Bank of Sri Lanka, 2004).

In order to operate a finance company in Sri Lanka, Finance Companies Act, No 78 of 1988 emphasises the need to meet the following criteria: (1) minimum amount of capital requirement to be maintained; (2) maximum amount of share, an individual could have in the issued capital; (3) personal responsibility of the directors for the operations, and (4) submission of periodical reports to the CBSL. As a result of these strict regulations, confidence of the general public was restored in the finance companies as evidently shown in the growth of the finance companies in the later years (Central Bank of Sri Lanka, 2004).

### ***Insurance Industry Act of 2000***

The insurance industry is one of the highly regulated sectors in the country. Regulation of Insurance Industry Act, No. 30 of 2000 has created the Insurance Board of Sri Lanka (IBSL). To operate insurance business in Sri Lanka, companies are required to get a licence from the IBSL (in addition to the incorporation complying the Companies Act, No. 7 of 2007), and are subject to regulations and supervision of the IBSL. Insurance industry has not only statutory regulations but also self regulations in the form of guidelines for better service to the customers. Insurance Ombudsman is the non-regulatory body which has power to inquire into and settle any complaints and disputes between individual customers and the insurance institutions.

### ***The Fair Trading Commission Act of 1987***

In order to protect the public interests from monopolies, mergers and anti-competitive practices, Government of Sri Lanka has enacted the Fair Trading Commission in 1987 under the Act of No.1 of 1987. Section 11 of the Act specifies that a complaint of an existence of monopoly, merger or anti-competition in the business sector, will get the attention of the Commission to look into whether any of the above or all is detrimental to the general public of the country. Accordingly, fixing a maximum price for a product or service, while protecting the return on investments, is a key task of this Commission. Institute of Policy Studies (2002) points out that the above Commission has investigated number of complaints of several listed companies in the last few years with some decisions to penalise, while some claims have been rejected. However, the lack of funds of this Commission prevents the proper administration of the tasks of the Commission (Institute of Policy Studies, 2002). The above discussion reveals that the public listed companies in Sri Lanka are subjected to a number of statutory regulations.

Therefore, what we see is that the economic enterprises are heavily regulated on the one hand and the regulations are scattered across several institutions on the other. This situation has been identified by Pierce and Waring (2004:333) as, 'in Sri Lanka, there is a plethora of regulations in many forms'. However, the selection of a regulatory system is a decision of the society. Governor of the CBSL speaking on the regulatory system of the banking industry in Sri

Lanka says that ‘one needs to be practical and sensible in deciding the appropriate system for its financial services industry. The size of the country, the track record of supervisory authorities and, more importantly, the close interaction between the supervisory authority and the institutions to be supervised, are important considerations (Jayawardene, 2002).

### 5. Evaluating the effectiveness of CG mechanism

Unlike in the UK, regulatory impact assessment studies have not been undertaken in Sri Lanka on a continuous basis (Institute of Policy Studies, 2005). Therefore, the effectiveness of the regulations is discussed with the use of reports and literature available with the limitation of having difficulties in seeing a holistic view of effectiveness.

According to Batra (2006), the Registrar of Companies in Sri Lanka works under limited resources. Therefore, the Registrar of Companies faces difficulties in achieving a full implementation of the overseeing responsibility, the state of compliance for the regulations on the submission of annual reports and the nature of disclosures in particular. ‘The office of the Registrar of Companies lacks the capacity to administer the official receivers and the liquidation process. They are not exposed to any education and training and are not schooled in best practices. However, ‘their integrity and independence are not in doubt’ (Batra, 2006:14).

Bhattacharya and Daouk (2002) argue that insider trading laws are not effective in the emerging countries. La Porta, De-Silanes and Shleifer (2006) have examined the security laws of 49 countries in which Sri Lanka has been included. These authors construct two indices namely the Disclosure Index and the Liability Index to see the strength of the security laws in a country.

The disclosure index is computed by number of dimensions. They are: (1) the nature of the prospectus in particularly the compliance of it in relation to legal provisions; (2) compensation of directors and (3) shareholder structure and inside ownership. Liability index comprises the ability of the investors to make a claim. Sri Lanka stands below the mean value of the English origin countries in all the indices (Table 5).

**Table 5**  
**Sri Lanka – Indices of Regulation of Securities Markets**

	<i>Mean Score</i>	
	Sri Lanka	Countries with English Laws applicable
Disclosure requirements	0.75	0.78
Liability Standard	0.39	0.58
Supervisor characteristics	0.33	0.48
Rule making power	1.00	0.67
Investigative power	0.50	0.75
Orders	0.00	0.57
Criminal sanctions	0.33	0.65
Public enforcement	0.43	0.62

*Source: La Porta, De-Silanes and Shleifer (2006:15).*

The first row shows the Sri Lanka situation and the second row shows the mean value for the countries where English law prevails. However, the value for disclosure is 0.75 and it is close to the mean value of 0.78. The value of regulations or the rule making power is 1.00 which is above the mean value of 0.67.

There is also evidence to show that implementation of the regulations has been further strengthened in recent years. In the annual report of the SEC (SEC, 2006), several cases of misconduct of the directors are mentioned along with the actions taken by the SEC. Among them is the selling of shares of family members of some directors at higher prices with the knowledge of sensitive market information. Such declarations in the annual report of the SEC on the conduct of the directors of the listed companies may deter the directors as violation of trading rules has been occurred. However, there is no follow up research to identify its effect. Abeysekera (2001) notes that SEC has made substantial progress to ensure market efficiency with 'freely available information, competition among investors and effective communication among market participants' (2001:251).

The responsibility and the emphasis of the auditors in Sri Lanka in early 1980s was to ensure that the company management prepares annual reports to show that there is a true and fair view of the accounts (Perera, 1980). Perera (1980:122) notes that 'there has been not much discussion in Sri Lanka on the rational behind annual reports and the information value of the financial statements they generate'. This scenario has been improved gradually. For example, the ICASL organises an annual competition to select the best annual report among the listed as well as the unlisted corporate sector since 1964. Since 2000, this annual competition focuses on three areas, namely, Good Corporate Governance Disclosure Award, Corporate Social Responsibility Reporting, and Management Commentary Award. Further, there is evidence to suggest that the authority is keen to see the implementation of the accounting and auditing standards.

Some international research studies find a better disclosure situation in Sri Lanka. Bushman, Piotroski and Smith (2003) in their research on corporate transparency of 45 countries selected during a period of five years from 1990 to 1995, points out that there are some promising countries which can take up the challenge of developing corporate governance in par with the developed countries and Sri Lanka is one of them. These authors have used a number of variables, namely, financial disclosures (segments reporting, capital expenditure on research and development and others, accounting policies, declaration about subsidiaries), governance disclosure (size of major shareholders, management personnel, boards and their remuneration, director and officer shareholdings), accounting principles, timeliness of disclosures, and credibility of disclosures. According to their findings, the best disclosure of governance information is found in Singapore (100 points) and next comes for Sri Lanka (97.83 points). UK accounts for 94.57 points, while the US stands for only 75.72 points. In disclosure variables, the UK, Canada, Australia, France, Germany, Japan, Ireland, Israel, Italy, Netherlands, Sweden and Switzerland are in equal footing (100 points) but the US is behind. Chairman of International

Accounting Standards Board (IASB) has praised the standards of accounting disclosures in Sri Lanka (Ceylon Daily News, 2005). Existence of number of regulatory bodies in Sri Lanka may a possible factor for the high level of disclosure

Although Bushman, Piotroski and Smith (2003) have not obtained the data on the number of audit firms in Sri Lanka and on the strength of the audit function in the quoted companies in Sri Lanka, 80 percent of the auditing of the corporate sector has been done by the internationally recognized audit companies (Handbook of Listed Companies, 2004). According to Bushman, Piotroski and Smith (2003:213), ‘...audit is a measure of the credibility of financial disclosures.

### **6. Issues and challenges of CG in Sri Lanka**

Common CG issues range from a simple misuse of shareholders funds such as the employment of a person not suitable for a job but known to the Chief Executive Officer (CEO) or spending to beautify the office of the CEO more than the needed comforts to discharge the duties or pure thefts and payment of salary and bonuses not commensurate with job performance etc. are among a large number of ways of deviating the shareholders funds discussed across many countries by the researchers (Berle and Means, 1933; Healy and Wahlen, 1999; Leuz, Nanda and Wysocki, 2003).

Similarly, in the recent past, a number of CG problems in Sri Lanka have been reported. They include issues such as the collapse of number of finance companies in mid 1980s, and misuse of funds of a private commercial bank and a finance company in mid 1990s and early 2000. However, the tax payers had to bear the minimum cost due to prompt action taken by the Government and the Central Bank of Sri Lanka (Central Bank of Sri Lanka, 2008).

The growth of the number of quoted companies since 1978 shows the emergence of wide participation in the equity capital and the eventual and inevitable emergence of agency conflicts (e.g. Fama and Jensen, 1983).

Although there is an international presence of audit firms, majority of the corporate sector have not yet developed audit committees. In a survey done by the SEC to see the level of establishment of audit committees, SEC found that only 62 percent of companies have established audit committees (out of 132 companies responded to a survey of 239 companies as at July 20, 2005) (SEC, 2005). This report shows many grey areas in audit related functions such as the inclusion of the CEO and some other executives also in the audit committees. Pierce and Waring (2004) find that the audit committees in the listed companies in Sri Lanka spend only around 15 minutes together and in some occasions hardly any attendance by the full committee members even.

Using data from the Worldwide Governance indicators for 2005, the World Bank (2006) reports that democratic accountability and clean government go hand in hand’ (2006:7). The politicians and the officers well understand the need to protect independence to develop free trade but they do not allow the legal framework to establish its root (Irvin, 2001; La Porta *et al.*,

2004). La Porta *et al.*, (2004) find that politicians who get a rent from the business community prevent competition in order to enjoy the privileges. Business firms get abnormal profit as a result and they too make various barriers for the new firms to come.

Political interferences affect the implementation of the regulations in the country as found by many authors. Thus, the protection of the interests of the shareholders and the other stakeholders are at stake even though the regulatory framework is in force (Weerakoon, 1995; Wickramasinghe, Hopper and Rathnasiri, 2004; Ratnayakara, 2006). Ratnayakara (2006, p.1) referring to the political influences states;

“Despite all the rules and regulations protecting various stakeholders, we have seen gross violations against the rights of minority shareholders as well as customers and competitors in recent times by powerful individuals who are able to throw their weight and flex their muscle in addition to dropping names thus instilling fear in the minds of regulators, in resorting to the acts. Very often are powerful stakeholder infringes on the rights of other stakeholders, competitors, employees, minority shareholders and even the fellow directors”.

The freedom for entrepreneurs to establish business could be measured by several indicators. Miles, Holms and O’Grady (2006) define economic freedom as ‘the absence of government coercion or constraint on the production, distribution, or consumption of goods and services beyond the extent necessary for citizens to protect and maintain liberty itself’ (Miles, Holms and O’Grady, 2006:56). In order to measure economic freedom, these authors used fifty economic variables categorising them into ten broad categories, i.e. trade policy, fiscal burden of government, intervention of the government in the economy, monetary policy, capital flows and foreign investment, banking and finance, wages and prices, property rights, regulation and informal market activity. All of these variables are treated equally important. The overall economic freedom score of a country is based on the simple average of ten individual factor scores. The score for each factor varies from one to five. A score of one signifies an economic environment or set of policies that are most conducive to economic freedom, while a score of five signifies a set of policies that are least conducive to economic freedom. Four broad categories of economic freedom in the index are: Free (countries with an average overall score of 1.99 or less), Mostly free (countries with an average overall score of 2.00 to 2.99), mostly un-free (countries with an average overall score of 3.00 to 3.99) and repressed (countries with an average overall score of 4.00 or higher). According to this index, Sri Lanka belongs to mostly un-free category with a score of 3.19.

Economic and political freedom is two other significant factors which decide the state of protection of rights of investors in a country (Reed, 2004). La Porta *et al.*, (2004) measure political freedom by several sources such as an index of political rights, democracy index, and index of human rights (2004:452). Barro (1999) introduces an easy to understand measure of political rights categorised into seven on the basis of the amount of electoral rights. Group one is

the highest level of rights and groups seven is the lowest. Sri Lanka has been included in between the democracy and dictatorship (Barro, 1999). Among many other factors, bureaucratic inefficiency (Mauro, 1995) and poor enforcement of law (La Porta *et al.* 1999) result in creating a large *shadow economy*, in developing countries including Sri Lanka (Schneider and Enste, 2000). These authors point out that the percentage of the shadow economy in Sri Lanka is around 38-50 percent. This is no doubt a very large drain of, otherwise the legitimate property of the general public or the potential investors.

Filatotchev *et al.*, (2007) identified the significance of the role of institutional investors as a corporate governance mechanism. In a developing country like Sri Lanka, domestic institutional investors could play a vital role in many forms in the capital market as pointed out by Reisen (2000), i.e. by making information available, increasing market liquidity, lowering transition costs, facilitating market participation by the general public, helping businesses raising capital, making privatisation possible, playing a role in corporate monitoring and attracting foreign investors. According to Pierce and Waring (2004), investor activism and stakeholder activism is in increasing trend in Sri Lanka, although it is not sufficient.

## 7. Conclusion

The above discussion points out that Sri Lanka have a growing corporate sector and a large scale regulatory framework established with the growth of the corporate sector since the introduction of the free market policies in 1977. However, as Anand (2006) points out the balance of both regulatory and non-regulatory codes on corporate governance brings harmony and less cost for both companies and the regulators. The paper argues that statutory rules and regulations enforce compliance cost for the companies and even could stifle the growth of the corporate sector especially the firms seeking the equity capital. *Sarbanes-Oxley Act 2000* has discouraged some firms to enter the equity market and also some firms now tend to go back to leveraged buy-outs and privatise (Dalton and Dalton, 2005; Zhang, 2007).

The regulatory bodies also have to meet the cost of maintenance of office and a professional staff to see that listed firms comply with the regulations (FSA, 2006). However, if there are only non-regulatory codes on corporate governance, the investors have to bear the cost of verifying the state of corporate governance in each and every firm they wish to invest (Anand, 2006). Investors are unable to find out the nature of corporate governance or about the true nature of declarations in financial statements due to the lack of knowledge and resources (Turnbull, 1997). Due to information barriers, the investors would not be able to get a correct picture of the firms. Therefore, a balance of both statutory regulatory and non-regulatory codes on corporate governance could be effective (Anand, 2006).

As indicated in the paper, there is a need for in depth studies examining the CG practices in emerging economies and CG practices in these countries have not come under scrutiny. For example, little is known about the appointment of non-executive directors, their sources of origin, training, evaluation and their in comparisons to the situation in developed capital markets (Higgs, 2003). The external corporate governance mechanisms too are not transparent enough

and are not fully functional due to the smallness of the corporate sector. There have been few corporate takeovers but the process and the outcome is not so transparent due to the involvement of the politicians in the process. Researchers must come forward to develop a research agenda especially in behavioural side of corporate governance in the country. This paper shed some light in this regard.

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