Corporate Governance Developments in Sri Lanka

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1. Introduction

Corporate governance issues have attracted much of the attention of academics, researchers, investors, regulators, and policy makers with the collapse of mega corporate entities such as Enron and WorldCom and recent global financial crisis. This has also been witnessed increasingly in Sri Lanka with the collapse of Pramuka Bank and Golden Key Credit Card Company. In light of these developments, Institute of Chartered Accountants of Sri Lanka (ICASL) and the Securities and Exchange Commission (SEC) in conjunction with the Colombo Stock Exchange (CSE) have introduced a number of voluntary and mandatory codes of best practice of corporate governance in order to improve corporate governance of listed companies in Sri Lanka. The primary objective of this paper is to provide an overview of corporate governance issues and to discuss corporate governance developments in Sri Lanka.

2. Background to corporate governance issues

The agency theory is the dominant theoretical perspective underlying corporate governance issues. The agency perspective of corporations was first introduced by Berle and Means (1932), who observe a separation between ownership and control in large US corporations. The separation of ownership and control in large corporations with diffuse ownership makes it difficult for shareholders to monitor management's decisions. This gives managers the freedom to pursue their own objectives at shareholder expenses (Berle and Means, 1932). Building on Berle and Means's argument, Jensen and Meckling (1976) systematically apply the principal agent perspective to model the potential agency costs resulting from agency problems in corporations. The agency problem arises from the agency relationship whereby one party (the principal) appoints another party (manager) to act on his/her behalf in the corporation. By providing a new paradigm of the firm as a "nexus of contracts" mainly between the principal and his/her agents, agency theory advances our understanding of the firm beyond that offered by the "legal entity" concept in law, or the "factor of production" concept in economics (Alchian and Demsetz, 1972; Jensen and Meckling, 1976). The agency cost theory adds therefore a new dimension to the theory of firm.

Jensen and Meckling (1976, p. 308) define the agency costs as the sum of (1) the monitoring expenditures by the principal, (2) the bonding expenditure by the agent, and (3) the residual loss. Given the considerable losses to the economy as a whole that follow from agency costs (Alchian and Demsetz, 1972; Jensen and Meckling, 1976), agency theory is considered as a dominating theoretical and empirically valid perspective in the governance of corporations (Shleifer and Vishny, 1997; Eisenhardt, 1989).

More recent years have witnessed an explosion of research on corporate governance issues in emerging markets such as China and Asian and East European countries. These studies (e.g., Faccio et al., 2001; Allen, 2005; Morck et al., 2005; Young et al. 2008) suggest that, in addition to the traditional principal agent problems, in emerging markets where ownership is concentrated and legal protection for minority shareholders is rather weak, majority shareholders tend to expropriate minority shareholders through various means like tunnelling, insider trading, dividend policy and leverage. This principal – principal perspective of agency problem affects decisions made by managers and consequently corporate performance (Faccio at al., 2001; Morck et al., 2005)

3. Definition of corporate governance

The above discussion indicates the important of corporate governance mechanisms to use resources efficiently and effectively in order to meet the interest of all the stakeholders. There is no single and generally accepted definition of corporate governance and existing definitions vary widely. A claimholders/ financiers-focused definition is given by Shleifer and Vishny (1997). They put it as "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment" (Shleifer and Vishny 1997, p.737). A similar focus can be seen in Denis and McConnell (2003, p.2) who define corporate governance as "the set of mechanisms- both institutional and market-based that induce the self-interested controllers of a company (those that make decisions regarding how the company will be operated) to make decisions that maximize the value of the company to its owners (the suppliers of capital)". A somewhat broader definition is provided by the Cadbury Committee (1992) which defines it

as "the system by which companies are directed and controlled". Similarly, Zingales (1998, p.499) broadly defines a governance system as "the complex set of constraints that shape the ex-post bargaining over the quasi-rents generated by the firm".

It is very clear from the above variety of definitions that corporate governance plays a central role in the direction and control of the corporations in order to ensure the interest of shareholders and other stakeholders are met through efficient and effective use of resources. A central theme of corporate governance research revolves around the establishment of mechanisms aimed at attenuating the conflict of interest between shareholders and managers, as well as between majority shareholders and minority shareholders, thereby mitigating agency costs. This is the predominant issue underlying corporate governance theories. To solve the agency problems various governance mechanisms have been devised such as monitoring by the board of directors/ large shareholders, providing equity ownership and compensation to managers, the use of debt financing, the discipline by capital markets and the managerial labour market, the market for corporate control and so on.

4. Development of corporate governance in Sri Lanka

Since 1977, Sri Lanka has adopted open economic policies. In line with these policies government has privatised many of the state owned enterprises and private corporate sector has emerged as a major player in the economy. The number of listed firms has more than doubled from 141 in 1977 to 294 in 2014.Since then governance of corporations has become one of the important considerations in Sri Lanka. As in other emerging markets like China and other Asian countries, corporate governance in Sri Lanka has evolved and developed in line with the economic liberalization policies undertaken in the country. Furthermore, corporate governance system in the UK also significantly influenced corporate governance developments in Sri Lanka as the country had been subject to British colonial rule for over 150 years (Senaratne & Gunaratne, 2008, Senaratne, 2011). In order to attract foreign direct investment, organizations such as the World Bank and International Monetary Fund (IMF) have also promoted better governance for their member countries and wider networks.

Initial corporate governance developments in Sri Lanka began in the late 1990s with the introduction of a voluntary code of best practice on matters relating to the financial aspects of corporate governance in 1997 by the Institute of Chartered Accountants of Sri Lanka (ICASL). This was based on the recommendations of the 'Financial Aspects of Corporate Governance Committee' which was led by Sir Adrian Cadbury and had a remit to review those aspects of corporate governance relating to financial reporting and accountability (also known as the Cadbury Code- 1992 and the first code of corporate governance introduced in the UK). This first ICASL Code outlined a number of recommendations around the structure and responsibilities of the board of directors; the role of auditors; transparency of financial reporting and the rights and responsibilities of shareholders.

There were further developments in the corporate governance in the UK with respect to structure and operations of the board, directors' remuneration, accountability and audit, relations with institutional shareholders, and the responsibilities of institutional shareholders. Based on these developments, ICASL issued the 'Code of Best Practice on Corporate Governance' in March 2003 replacing the previous code introduced in year 1997.

ICASL Code (2003) introduced principles on corporate governance under two main captions namely, The Company and Institutional Shareholders. While the former section provided principles on corporate governance in relation to four main aspects: directors; directors' remuneration; relations with shareholders; and accountability and audit, the latter section provided principles on corporate governance in relation to institutional investors and other investors. In the UK, it was expected that institutional shareholders can play an effective role in the governance of corporations.

In addition, a number of supplementary codes and guidelines on specific aspects or areas of corporate governance also were developed in Sri Lanka, namely (i) 'ICASL Code of Best Practice on Audit Committees 2002' to provide detail guidance on the scope and functions of the audit committee of listed companies, (ii) 'Code of Corporate Governance for Banks and Other Financial Institutions 2002' issued by the Central Bank of Sri Lanka and (iii) 'Guidelines for Listed Companies in respect of Audit and Audit Committees 2004' issued by the Securities and Exchange Commission (SEC).

One of the important developments in corporate governance in Sri Lanka is the introduction of the Code of Best Practice on Corporate Governance (2008) by ICASL and the Securities and Exchange Commission (SEC) in conjunction with the Colombo

Stock Exchange (CSE) for voluntary compliance of listed companies in conjunction with the mandatory rules on corporate governance. The mandatory rules have been incorporated into the Listing Rules of the Colombo Stock Exchange and have been adopted by all listed companies from the financial year commencing on 1st April 2008. The Section Seven of the Listing Rules (the section on continuing listing requirements) deals with these rules on corporate governance that prescribes

- the minimum number of nonexecutive and independent directors to be present on the board,
- the criteria for determining 'independence' of non-executive directors,
- disclosures required to be made in respect of the directorate, and
- the minimum requirements to be met in respect of the audit committee and the remuneration committee.

As a further development in the mandatory codes, the Central Bank of Sri Lanka (CBSL) has also introduced a mandatory code of corporate governance in the form of the Banking Act Direction No. 01 of 2008 on Corporate Governance for Licensed Commercial Banks in Sri Lanka in April 2008. All licensed commercial banks were expected to comply fully with this code by 1st January 2009. The objective of this code is to promote a healthy and robust risk management framework for banks with accountability and transparency through policies and oversight by the board of directors. Additionally, the CBSL has issued Direction, No. 03 of 2008 on Corporate Governance for finance companies registered under Section 2 of the Finance Companies Act, No. 78 of 1988. It sets out principles and rules in relation to finance companies based on the same aspects described above. The compliance with this code is also mandatory from year 2009. Mandatory rules on corporate governance for banking and finance companies are required due to their economic and social vulnerability to the country (Senaratne, 2011).

All these developments in the corporate governance in Sri Lanka were mainly based on the series of corporate governance developments that had taken place in the UK. Since corporate Governance is a dynamic force that keeps evolving to address new issues and challenges, the Institute of Chartered Accountants of Sri Lanka and the Securities and Exchange Commission of Sri Lanka once again taken a joint initiative to review and revise the Code of Best Practice on Corporate Governance, issued in 2008 taking into account the changes taking place in other parts of the world.

This revision took into consideration relevant developments in best practices worldwide and emerging matters specific to Sri Lanka. Corporates are encouraged to adopt this Code in discharging their corporate governance responsibilities.

Key amendments in this version include;

- reporting internal control, risk management and related responsibilities of the Audit Committees and Boards of directors.
- reporting requirements of the remuneration committees.
- role of the company secretary in Corporate Governance.
- communication with shareholders.
- disclosure and approval of major and material transactions, including those with related parties.
- sustainability reporting

5. Conclusion

Major Concerns of Corporate Governance are to align the interests of managers and shareholders, prevent managers from pursuing own interests, prevent high and excessive executive pay, overcome agency costs associated with the separation of ownership and control and avoid abuse of power. In Sri Lanka, ICASL, SEC, CSE and Central Bank of Sri Lanka have taken several measures to improve the governance of listed companies. Firstly, ICASL introduced voluntary codes, which do not prescribe the corporate behaviour in detail but try to secure sufficient disclosures on corporate governance so that stakeholders of corporate entities can assess the corporate governance practices and respond in an informed way. However, through joint initiatives of ICASL, SEC and CSE mandatory codes on corporate governance have been introduced in addition to comprehensive voluntary codes to improve governance of listed companies. However, there is a lack of rigorous empirical research to assess the effectiveness of the corporate governance practices in Sri Lanka.

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