

Corporate Governance Reforms in Sri Lanka¹

Samanthi Senaratne*

Abstract

Over the last two decades corporate governance practices have gained increased attention mainly owing to the questionable business practices and corporate scandals that had taken place globally. This made introduction of corporate governance reforms a high priority in most countries in the world. In this context, the objective of this study is to examine how corporate governance reforms have taken place in Sri Lanka, their salient characteristics and their implications on the corporate sector. This study had been carried out as an exploratory study of corporate governance reforms introduced from 1997 to 2008, the period in which the main reforms had taken place in the country. These reforms have been carried out in Sri Lanka via the introduction of codes of best practices on corporate governance, which advocate core corporate governance perspectives such as improvement of accountability, integrity, efficiency, and transparency that the companies should follow to ensure their sustainability. A common feature of these reforms is their close allegiance to the Anglo-Saxon Model of Corporate Governance, which enjoys hegemony in corporate governance reforms around the globe. However,

1. This paper has been developed based on the PhD thesis 'Level of informativeness of annual reports and corporate governance : A study of Sri Lankan quoted public companies and the subsequent studies done by the author on corporate governance in Sri Lanka.

* Professor in Accounting, Department of Accounting, University of Sri Jayewardenepura, Gangodawila, Nugegoda, Sri Lanka.

this model is in conflict with some key features of corporate sector in Sri Lanka particularly with the concentrated corporate ownership structure. This shows that the main issue that stems from Anglo-Saxon Model based corporate governance reforms in Sri Lanka is the gap between the homogeneous corporate governance best practices *and* the heterogeneous nature of societies and institutions in which these reforms are being implemented. Thus, it is questionable whether corporate governance reforms introduced in Sri Lanka could play a crucial role in sustaining a business.

Keywords : Anglo-Saxon - Corporate Governance - Ownership - Political Economy - Reforms

Introduction

Governance has become an issue of interest ever since people began to organize themselves for a common purpose. As corporate form of entity is considered as one way of organizing people towards a common purpose, corporate governance has become a critical area of concern. It has also become a much discussed issue today owing to constant occurrence of corporate frauds, abuse of managerial power and social irresponsibility of corporate entities. Therefore, a quest for good corporate governance can be witnessed today.

The term 'corporate governance' is usually defined as the system by which companies are directed and controlled (Cadbury Report, 1992). The Organization for Economic Corporation and Development (OECD) (1999) provides the following elaborate functional definition on corporate governance.

'The corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it provides the structure through which the objectives of the company are set, and means of attaining those objectives and monitoring performance.'

The essence of these definitions is that the corporate governance is the system and processes by which companies are supervised, directed and controlled as well as the way directors discharge their accountability to shareholders and other stakeholders of a company. However, corporate governance has wider implications to the economic and social well-being of a country, *first*, in providing the incentives and performance measures to achieve business success and *second*, by providing the accountability and transparency to ensure the equitable distribution of the resulting wealth (Clark, 2004). The contribution of corporate governance for the stability and equity of society is aptly captured by the following definition of Adrian Cadbury made in 2004:

“Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society.”

These wider social and economic implications have made corporate governance a global issue. Thus, the introduction of corporate governance reforms has become a high priority in both developed and developing countries in the world. However, the impetus for corporate governance reforms in both developed and developing countries has much deeper roots relating to the larger historical experience of the countries in question and structural changes in the global political economy (Reed, 2004a). These deep roots affect the nature of corporate governance reforms carried out in these countries. This has resulted in practising different systems of corporate governance in the world.

These different systems of corporate governance can be broadly demarcated as Anglo-Saxon (market-based) Model of Corporate Governance in the United States of America (USA) and United Kingdom (UK), *and* Relationship-based (insider-system) Model of Corporate Governance in Europe and Asia-Pacific

Countries. Sheard (1998) points out that the key difference between the two systems relates,

“to where the locus of corporate monitoring and control resides and how circumscribed the rules of the game, and participation in it, are. In an insider-based system, corporate governance functions are carried out by a small number of readily identifiable economic agents, such as “main banks” or large parent firms, and corporate control events are subject to a high degree of internal regulation by the key parties concerned, including incumbent management. In market-oriented systems, a diverse set of monitoring and control mechanisms exist and which one prevails in a given set of circumstances is left to competitive market forces.”

The key distinction between the two systems is made in relation to 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). These systems of corporate governance that have been evolved in the developed countries have been transmitted to developing countries via corporate governance reforms. Hence, an important issue to investigate is how corporate governance reforms have been carried out in Sri Lanka.

In this context, the objective of this study is to examine how the corporate governance reforms have taken place in Sri Lanka, *and* their salient characteristics and implications on the corporate sector. Sri Lanka is one of the fastest growing emerging markets in the South Asian Region and follows an open economic policy from the year 1977. The open economic policies have lead to a revival in the country’s corporate sector and as a result, governance of corporate entities has become an important area of consideration. Hence, corporate governance reforms in the country have taken place in combination with the economic liberalization policies undertaken in the country. Further, the influence of British systems is visible in many areas including in corporate governance reforms as the country had been subject to British colonial rule for over 150 years (Senaratne & Gunaratne, 2008a). Thus, this study examines

the corporate governance reforms in Sri Lanka in the larger context in which they have been carried out in the country.

This study had been carried out as an exploratory study of corporate governance reforms introduced in Sri Lanka from the year 1997 to year 2008, the period in which the main reforms had taken place in the country. The findings of the study have been analyzed by drawing inferences from the extant literature on corporate governance reforms and previous studies done by the author on corporate governance model and practices in Sri Lanka. It is important to explore how corporate governance reforms have been undertaken in the country to identify their prospects, the associated issues and the adherence of corporate entities to these reforms. Hence, this exploration and analysis would provide useful insights into future corporate governance reforms in Sri Lanka. Although the findings of this paper specifically relate to Sri Lanka, they could have implications on other countries, which have undertaken similar corporate governance reforms.

The remainder of the paper is organized as follows. Section 2 presents the state of corporate governance reforms in Sri Lanka during the period 1997 to 2008. Section 3 describes the Anglo-Saxon nature of the corporate governance reforms carried out in Sri Lanka. Section 4 presents concerns raised as to the application of Anglo-Saxon Model of Corporate Governance in the Sri Lankan context. Section 5 presents the conclusions of the study.

State of Corporate Governance Reforms in Sri Lanka

Corporate governance reforms were introduced in Sri Lanka from late 1990s by way of codes on corporate governance best practices, which sets out recommendations on the responsibilities, structure and organization of the board of directors with the aim of improving its monitoring role. These codes have been developed on the assumption that ownership and control of corporate entities are separated *and* as a result, the board of directors is pivotal in the relationship between the shareholders (owners of resources) and

the management (controllers of resources) of these entities. Hence, the central issue addressed in these codes is the protection of shareholders' rights² that delineates the separation between ownership and control.

Firstly, these codes were issued as 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, lately, alongside with these voluntary codes, a number of mandatory codes on corporate governance have been introduced. A main feature of all these codes is that they have been devised based on the developments that had taken place in this respect in UK.

Both these voluntary and mandatory codes mainly focus on improving the governance practices of companies listed on the Colombo Stock Exchange (CSE). As these companies raise public funds, they are considered as most accountable entities in the society. Further, some of the mandatory codes deal with economically vulnerable sectors such as banking and finance companies. As these institutions depend on the public deposits they are largely accountable to the society. The corporate governance reforms introduced via these codes and mandatory rules are described in the subsequent sections.

2. *OECD Principles (1999 and 2004) classify shareholders' rights into two main categories: (1) Bundle of rights that constitute ownership and (2) Shareholders' rights delineates the separation between ownership and control. The rights associated with the ownership are usually protected by the Company Law of the country. On the other hand, the focus of Corporate Governance Best Practice is mainly on the second category. Since OECD (1999 and 2004) sets out an international benchmark on corporate governance for individual countries to develop their own frameworks, it covers both types of shareholders' rights. However, the Codes of Best Practice developed in individual countries mainly focus on the second category of shareholders' rights.*

a) Voluntary Codes of Best Practice on Corporate Governance

The first voluntary code of best practice introduced in Sri Lanka is the 'Code on Best Practice on matters relating to Financial Aspects of Corporate Governance' issued in December 1997 by the Institute of Chartered Accountants of Sri Lanka (ICASL) to deal with financial aspects of corporate governance. This was a blueprint of the Cadbury Code (1992) - Financial Aspects of Corporate Governance; the first code of corporate governance introduced in UK and is also considered as the first code of best practice developed based on the Anglo-Saxon Model of Corporate Governance. The Cadbury Code was designed to achieve the necessary high standards of corporate behaviour through strengthening the unitary board system (board which consists of both executive and non-executive) and increasing its effectiveness. This same objective was embraced in the ICASL Code and it dealt with the following aspects covered in the Cadbury Code: the structure and responsibilities of the board of directors; the role of auditors; *and* the rights and responsibilities of shareholders.

Owing to the changes that had taken place in corporate governance landscape in the world, ICASL issued the 'Code of Best Practice on Corporate Governance' in March 2003 replacing the previous code introduced in year 1997. This new code was largely based on the Hampel Code (1998) (also known as UK Combined Code 1998). Hampel Code endorsed a majority of findings of both Cadbury Code and Greenbury Code (1995), which set the best practice in determining and accounting directors' remuneration. However, it did not concern solely on the prevention of abuse (which was the focus of both Cadbury and Greenbury Codes³). It is equally concerned with the positive contribution which good corporate governance can make. Hence, the focus of Hampel code was much

3. Both Cadbury Code and Greenbury Code codes had been issued in response to things which were perceived to have gone wrong- issued in response to corporate failures in the first case and unjustified compensation packages in the privatized utilities in the second. Thus, both these codes focused largely on the prevention of abuse.

larger compared to the previous codes and it identified principles of corporate governance in relation to the role of directors, directors' remuneration, role of shareholders *and* audit and accountability. ICASL Code (2003) too followed the same pattern and accordingly it identified principles on corporate governance under two main headings: The Company and Institutional Shareholders. The section on 'The Company' provided principles on corporate governance in relation to four main areas: directors; directors' remuneration; relations with shareholders; *and* accountability and audit. On the other hand, the section on 'Institutional Shareholders' provided principles on corporate governance in relation to institutional investors and other investors.

However, by this time, UK had gone a long way forward by introducing the Combined Code (2003) which superseded and replaced the Combined (Hampel) Code (1998), by drawing from three other codes that were developed between 1998 and 2003 to deal with some specific areas of corporate governance - Turnbull Report on Internal Controls (1999), Smith Report on Audit Committees (2003) *and* Higgs Report on Review of the Role and Responsibilities of Non-Executive Directors (2003). Further, Sarbanes-Oxley Act (which is considered as the single most important piece of legislation affecting corporate governance, financial disclosure and the practice of public accounting since the US securities laws of the early 1930) was introduced in USA in 2002 aftermath of the collapse of mega corporate entities - Enron and WorldCom. This shows that Sri Lankan codes on best practice have not kept pace with these latest global developments in corporate governance. However, a number of supplementary codes and guidelines to ICASL Code were developed during this period to deal with specific aspects or areas of corporate governance. These include '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, 'Code of Corporate Governance for Banks and Other Financial Institutions 2002' issued by the Central Bank of Sri Lanka *and* 'Guidelines for Listed Companies in respect of Audit and Audit Committees 2004' issued by the Securities and Exchange Commission (SEC).

The ICASL Code (2003) was subsequently replaced by the 'Code of Best Practice on Corporate Governance (2008)', which has been prepared by ICASL jointly with the SEC for voluntarily compliance of listed companies in conjunction with the mandatory rules on corporate governance that have been incorporated into the CSE Listing Rules. This Code provides a revised series of recommendations on corporate governance best practices under the two broad headings 'The Company' and 'Shareholders', by drawing largely from the UK Combined Code 2003 on Corporate Governance. The revised ICASL code is a comprehensive code, which covers principles on corporate governance in relation to directors, directors' remuneration, relations with shareholders, accountability and audit, institutional investors, *and* other investors. A special feature of this code is that it requires companies to adopt a Code of Business Conduct and Ethics for directors and senior management.

b) Mandatory Rules on Corporate Governance

The rules on corporate governance have been made mandatory for listed companies from April 2008 by incorporating them into the CSE Listing Rules. These mandatory rules have been developed through a joint initiative of ICASL and SEC in consultation with the CSE. 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 non-executive and independent directors to be present on the board, the criteria for determining 'independence' of non-executive directors, disclosures required to be made in respect of the directorate, *and* the minimum requirements to be met in respect of the audit committee and the remuneration committee. In respect of both audit committee and remuneration committee, the composition, functions and the relevant disclosures in the annual report have been specified. These rules have also been largely derived from international corporate governance codes especially from UK Combined Code 2003. However, these rules at first instance provide only the minimum standards to be met by a listed company. Hence, ICASL Code of Best Practice (2008) is expected to comply voluntarily by companies in conjunction with these mandatory rules.

Among other things this revised code addresses the following areas not covered in the Listing Rules: appointments to the board (establishment of a nomination committee); re-election of directors; performance evaluation of directors; separation of roles of chairman and CEO; supply of information to directors; board and board committee meetings; internal controls, financial reporting; relations with shareholders and the role of institutional shareholders (Senaratne & Gunaratne, 2008b). Thus, listed companies have to devise their corporate governance practices in line with both the mandatory rules included in the Listing Rules and the principles of ICASL Code (2008). The introduction of these mandatory listing rules on corporate governance can be considered as a significant move towards the improvement of governance practices of Sri Lankan listed companies in the context that there was a functional convergence (which refers more decentralized, market based and firm-level changes) in these companies to the previous voluntary codes of compliance (Senaratne & Gunaratne, 2007a). Thus, the compliance to voluntary rules was not a market-wide phenomenon. These findings highlight the need for form convergence in corporate governance practices, which refers to the changes in rules and enforcement mechanisms that tend towards some desirable standards.

On the other hand, the Central Bank of Sri Lanka (CBSL) has also issued a mandatory code of corporate governance - the Banking Act Direction No. 01 of 2008 on Corporate Governance for Licensed Commercial Banks in Sri Lanka in April 2008, which banks were expected to comply fully by 1st January 2009. This has been designed as a series of rules based upon certain fundamental principles, which would promote a healthy and robust risk management framework for banks with accountability and transparency through policies and oversight by the board of directors. It is a comprehensive code of corporate governance setting out principles and rules for responsibilities of the board, composition of the board, criteria to assess fitness and propriety of directors, management functions delegated by the board, roles of chairman and CEO, board committees, related party transactions *and* disclosure. Further, 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 are required to these sectors due to their economic and social vulnerability to the country.

c) Corporate Governance Reforms from Voluntary Codes to Mandatory Rules

The corporate governance best practices for Sri Lankan companies have been gradually evolved over a period of time from the introduction of the first voluntary code of best practice in 1997 to the mandatory codes on corporate governance in 2008. These codes advocate core corporate governance perspectives that the companies should follow: improvement of accountability; integrity; efficiency; and transparency, which are viewed as critical factors for sustainability of the companies, as their absence potentially lead to corporate failures. The developments in best practices have been influenced to a greater extent by the continuous international dialogue on the need to strengthen the corporate governance practices to achieve economic prosperity. However, the effectiveness of these corporate governance reforms needs to be addressed in relation to their origin specifically the specific form in which they have been undertaken and the prospects of these reforms in improving the development potential of corporate entities.

Anglo-Saxon Nature of Corporate Governance Reforms in Sri Lanka

The notable feature of corporate governance reforms in Sri Lanka is that these reforms have been introduced largely in line with Anglo-Saxon (marker-oriented) Model of Corporate Governance, which has become the dominant force in introducing corporate governance reforms in developing countries. Gay (2002) identifies the key characteristics of this model as (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. 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. This one-tier board is commonly described as a unitary board; (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. (Ownership concentration is low); (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 as disclosure based, as dispersed investors require reliable and adequate information flows in order to make informed investment decisions.

The global convergence towards Anglo-Saxon Model compared to the other systems of corporate governance can be attributed to the success of the new economy in the USA in the late 1990s. This process was further strengthened by the proponents of the 'globalization thesis of corporate governance', which sees the rise of foreign direct and portfolio investment as a force tending towards homogeneity in corporate governance reforms. However, Sri Lanka's inclination towards this model is associated with both historical and economic factors underlying corporate governance reforms (Senaratne & Gunaratne, 2008a). These factors have contributed towards the hegemony of Anglo-Saxon Model in corporate governance reforms in Sri Lanka as in the case of most other developing countries.

The historical reasons refer to strong historical ties of Sri Lankan corporate entities with Anglo-Saxon Model as a legacy of the British colonial rule in the country from 1796 to 1948. The introduction of corporate form of entities as well as share trading to Sri Lanka dates back to the British Colonial rule in the country. Even most of the corporate entities presently listed on the CSE also have roots dating back to British era. Senaratne (2007) finds two categories of such listed companies: (1) Companies that have

commenced during the British rule and continued after independence with or without foreign owners and (2) Companies that have commenced after independence through the amalgamation of several entities formed during the British rule. Even though indigenous businesses progressed after gaining independence in 1948, the traditional loyalty to this model did not fade away mainly due to the professional bias towards this system and development of Sri Lanka's company law based on the British company law (Senaratne & Gunaratne, 2008a). These factors show how the past history of the country has impacted on its corporate governance reforms.

On the other hand, the economic reasons include the adoption of liberalized economic policies in Sri Lanka and the influence of the international funding agencies such as World Bank and International Monetary Fund (IMF) on developing countries. With the adoption of liberalized economic policies in Sri Lanka in year 1977, private sector companies play the dominant role in the Sri Lankan economy and Anglo-Saxon Model is the logical counterpart to unleash the development potential of these companies. Business interests promoted by economic liberalism and deregulation tend to favour the Anglo-Saxon Model. This move has been further intensified by the economic globalization, which has changed the landscape of international political economy. Furthermore, the funding agencies usually advocate the use of a market based model on corporate governance through their structural adjustment programmes introduced in developing countries like Sri Lanka, who are at the mercy of these agencies due to poor economic performance. These programmes include a variety of features that induced a move towards an Anglo-Saxon approach to corporate governance.

Even though there are both historical and economic reasons associated with the adoption of the Anglo-Saxon Model of Corporate Governance by developing countries, it is questionable whether this adoption reflects a truly democratic process. This model has not evolved in these countries over a period of time to suit their economic, legal and other developments. Instead, the developing countries have adopted this model due to either its close allegiance to the

accounting and legal systems of these countries inherited from colonial masters or various international pressures discussed above. Hence, it is arguable whether such model could address fully the corporate governance requirements of developing countries like Sri Lanka. Aguilera *et al.* (2007) state that the common elements of Anglo-Saxon corporate governance often absent in other countries where corporate governance practices interact in different combinations and display a different set of complementarities. Senaratne and Gunaratne (2007a), which examined the corporate governance practices of Sri Lankan listed companies, identify that both positive and negative features are associated with them. While the positive features denote the upsurge in the development of corporate governance practices of Sri Lanka companies with the internationally accepted best practices introduced via corporate governance reforms, the negative features are mainly associated with the lack of necessary conditions for the successful implementation of the Anglo-Saxon Model in the Sri Lankan context. Thus, it is important to consider the issues associated with the implementation of Anglo-Saxon Model of Corporate Governance in Sri Lanka. These would provide insights in to the future corporate governance reforms in the country.

Concerns about Anglo-Saxon Model of Corporate Governance Reforms

Even though Anglo-Saxon Model enjoys hegemony in introducing corporate governance reforms in Sri Lanka, there are many concerns as to the suitability of these reforms. While some of these concerns are transitional in nature, others are more inherent and question the efficacy of the model as revealed in the similar studies done in other countries (Reed, 2004a). This section examines some of these main issues that have been raised in relation to the Anglo-Saxon Model of Corporate Governance in the Sri Lankan context. These are addressed under the headings ownership structure, shareholder approach, markets for capital and corporate control, external focus *and* political economy considerations.

(a) Ownership Structure

One of the main concerns about the model relates to the ownership structure of Sri Lankan companies. Most of the Sri Lankan companies are characterized by a high degree of ownership concentration with the presence of a controlling shareholder (Samarakoon 1999; Senaratne & Gunaratne, 2007b) in contrast to the widely held corporate ownership structure presumed in the Anglo-Saxon Model. Since the Anglo-Saxon Model assumes that corporate entities have a widespread equity ownership, these organizations are characterized by separation of ownership and control between shareholders and managers *and* thus, by a primary agency problem between the managers and the shareholders. However, owing to the high ownership concentration in Sri Lankan corporate entities, the primary agency problem is witnessed between the controlling shareholders and the minority shareholders *not* between the shareholders and the managers (Senaratne & Gunaratne, *ibid.*). This is a common phenomenon in developing countries. La Porta *et al.* (1999) have suggested that in developing countries the primary agency problem has historically been between majority (controlling) shareholders and minority shareholders *not* between the owners and the managers as usually advocated in the Anglo-Saxon Model. Hence, the corporate governance issues of these countries should be considered from this context.

The presence of a controlling shareholder has a strong impact on the corporate governance structure particularly on the appointment of directors, independence of non-executive directors, separation of roles of chairman and CEO, *and* succession planning and performance evaluation of directors (*ibid.*). This is mainly because of the controlling shareholder's power to install whoever he/she wishes as managers. The study also finds that the corporate control mechanisms such as pyramid and cross-holding ownership structures are used by the controlling shareholders to achieve control rights excess of cash flow rights in a company. Hence, this situation could lead to the possibility of worse corporate governance problems including the expropriation of minority rights by the controlling shareholders to gain private benefits, which is termed in the literature as 'tunnelling' (Johnson *et al.*, 2000). Tunnelling could create a

serious barrier to financial development as it would lead to thinning of capital markets and drying up of low-cost equity financing options for companies. Thus, the critical corporate governance issue in Sri Lanka is the protection of the rights of minority shareholders. However, it is questionable whether corporate governance reforms based on Anglo-Saxon Model could address this critical issue.

The presence of a controlling shareholder in most Sri Lankan companies is associated with certain cultural factors and inadequacies in the legal system of the country (Senaratne & Gunaratne, 2008a). In terms of cultural factors, the presence of a controlling shareholder is closely linked to the characteristic - collectivism. Hofstede (1994) reveals that Asian societies are collectivistic societies, which concern for much wider group and emphasize belongingness that can extend to organizations. Senaratne and Gunaratne (2007b) find that the ultimate controlling shareholder in most Sri Lankan companies is an individual or a family as in most other Asian countries (Claessens *et al.*, 2000; Bhattacharyya, 2004). The key concern of family ownership is that it leads to the majority of directorships in these companies being held by the family members and the transferring the management of the companies from one generation to another of the controlling shareholder family. On the other hand, inadequacies in the Sri Lankan legal structure for the protection of investors' rights have also contributed towards the presence of a controlling shareholder. Thus, corporate governance reforms should be considered from a broader context of socio-economic, political and legal factors of a country.

(b) Shareholder Approach

The central theme of the Anglo-Saxon Model is shareholder primacy advocated in the agency theory, where the board of directors is accountable mainly to the shareholders. The agency theory offers shareholders a pre-eminent position in the firm as its residual risk takers and suggests that shareholders are the principals in whose interest a company should be run even though they rely on others for the actual running of the organization. Although the shareholder approach is logically most compatible with the Anglo-Saxon Model,

it gives a narrow connotation to the roles and responsibilities of the board of directors, who is responsible for the governance of companies. Reed (2004b) cites that the justification of the shareholder model is based upon one of two foundations: libertarian approach, which is based on a claim of strong property rights and utilitarian analysis, which argues that companies can maximize social utility by focusing on shareholders' interests. Hence, central claim of this model lies on the idea that the maximisation of shareholder value provides the best avenue for maximising the performance of the economic system as a whole and thereby the well-being of citizens in the society. However, this position contradicts the concentrated ownership structure prevalent in countries like Sri Lanka where the controlling shareholder has the power to determine the policies of a company and as a result, the critical governance issue is the protection of the rights of minority shareholders and other stakeholders of the company from the power of the controlling shareholder *not* the protection of shareholders in general from the opportunism of managers.

This type of a model may not effectively address the needs of other stakeholders of the company as it was clearly evident in corporate collapses such as Enron, WorldCom and Golden Key. These cases highlight even though agency theory based governance model looks at the self-interested inclination of corporate management, it does not consider relationship of a company with its different stakeholders and thereby fails to address their concerns. In contrast to this shareholder approach advocated in Anglo-Saxon Model, stakeholder models of corporate governance argue that companies have responsibilities to parties other than shareholders and that any fiduciary obligations owed to shareholders to maximize their wealth is subject to the constraint of respecting obligations owed to other stakeholders of the organization. Thus, in order to comprehend the reality of corporate governance in a country, it is necessary to understand the relationships among different constituencies of a company. This requires a broader perspective to be embraced in future corporate governance reforms in Sri Lanka.

(c) Markets for Capital and Corporate Control

A key characteristic of the Anglo-Saxon Model is the presence of a liquid capital market in the country and a fairly rigorous market for corporate control. In this governance model, the capital market occupies a centre stage in terms of channelling society's savings to firms, exerting corporate control and easing risk management. Even though Sri Lankan capital market is growing fast, it is still an emerging market and thus funds are mainly raised by companies through banks and other financial institutions. In addition, the investments in the CSE by the general public is at a fairly low level despite Sri Lanka being one of the fastest growing emerging capital markets in the world. This is to a certain extent associated with elitism (i.e. dominance of an elite group of businessmen or families) and emerging business class with political power (this is referred in literature as 'crony capitalism') in the Sri Lankan society (Senaratne & Gunaratne, 2008a). These factors could also act as a barrier for the successful implementation of the Anglo-Saxon Model in Sri Lanka. On the other hand, this model expects that an active takeover market would discipline the underperforming managers through the exit option available to shareholders. However, Senaratne and Gunaratne (2007b) find that the concentrated ownership structure of Sri Lankan listed companies act as a barrier to have an effective corporate control market in Sri Lanka, which is an external corporate governance mechanism in developed capital markets. This study reports that in the Sri Lankan context corporate takeovers usually take place not when there is a failure in the management but to enhance the power of certain individuals or groups of companies. Thus, many Sri Lankan companies being characterized by a high degree of ownership concentration acts as a hindrance to have an active takeover market, a liquid stock market, and arms-length institutional shareholders. Since the development potential of Anglo-Saxon Model rests upon the premise of competitive markets, these limitations associated with the capital market and corporate control market restrict its ability to function effectively in the Sri Lankan context. These limitations in turn are associated with the unique socio-economic characteristics of developing countries in contrast to Anglo-American countries where this model has been evolved.

(d) External Focus

The Anglo-Saxon Model, which is based on agency theory, examines only the internal monitoring dilemmas of corporate governance. However, a corporate entity is an open system, which interacts with the external environment. It is influenced by, and influences, the environment in which it operates. The validity of this interrelationship is clearly visible in corporate scandals that had taken place in the world. Hence, it is necessary to consider the external challenges of corporate governance, an aspect that is not sufficiently addressed in the Anglo-Saxon Model. This requires corporate governance reforms to take into consideration some theoretical approaches such as resource dependency theory, institutional theory and network theory that focus upon the external challenges of corporate governance in terms of building relationships and securing resources without limiting to the universalistic approach to corporate governance advocated in the Anglo-Saxon Model.

The resource dependency theory proposes corporate boards as a mechanism for managing external dependencies, reducing environmental uncertainty and reducing the transactions costs associated with environmental dependency (Hillman *et al.*, 2002). This role of directors provides access to relationships with suppliers, customers, public policy makers and other social groups without limiting their relationship to shareholders. In recent times, intensified external pressures for greater corporate accountability has focused more on board involvement in the strategic decision making process. Institutional theory could also be used to conceptualize the board response to these external pressures. Although there are several distinct schools of thought within this perspective, much of the institutional theory literature focuses on the concept of isomorphism, whereby organizations conform to the accepted norms of their populations (DiMaggio & Powel, 1983). Hence, the institutional theory addresses the use of governance structures and processes by corporate entities that an environment legitimates as sensible because it implies responsible management, pleases external constituencies and avoids potential claims of negligence if something goes wrong (Eisenhardt, 1988). This is a common phenomenon in many closely held companies in Sri Lanka including the listed

companies with a concentrated ownership structure (Senaratne & Gunaratne, 2008b). In this context, it is important to consider the network theory on corporate governance. Though there are different definitions on network governance, they cluster around two key concepts: (1) patterns of interaction in exchange and relationships and (2) flows of resources between independent units (Jones *et al.*, 1997). In network governance, coordination is characterized by social systems rather than by bureaucratic structures within firms and formal contractual relationships between different entities in the same group. This is particularly applicable to Sri Lankan business entities, which are related with each other via cross-holding of shares and the ultimate controlling shareholder is an individual or a family.

Even though the arguments put forward by these theories have validity in explaining the situation prevailing in most companies in Sri Lanka, the existing model of corporate governance does not address these issues as identified in the study of Senaratne and Gunaratne (2008b). This study finds that the existing model of corporate governance focuses mainly on having appropriate checks and balances over management as it has been developed on the assumption that the ownership of listed companies is separated from the management resulting in the shifting of power and control from shareholders to management. Thus, the distinct role that directors play in providing essential resources or securing those resources through linkages to the external environment is not taken into consideration in this model.

(e) Political Economy Considerations

The issues deliberated in the preceding sections show that some basic conditions necessary for the effective implementation of Anglo-Saxon Model of Corporate Governance do not exist in the Sri Lankan context. These necessary conditions are the ownership dispersion in corporate entities, presence of institutional shareholders, the central role the capital market play in the economy and the availability of an active takeover market (Senaratne & Gunaratne, 2008b; Senaratne, 2009). This is owing to the variations in the economic, social, and political landscape of the country from that of Anglo-American countries, where this model has originated.

This has been identified as a common phenomenon in many developing countries. Krambia-Kapardis and Psaros (2006), who report the experience of Cyprus in implementing a corporate governance code developed largely on Anglo-Saxon Principles, show that only a minority of listed companies have complied with all significant aspects of the code. This study finds that low level of compliance as an outcome of the infancy of Cyprus equity market and corresponding legislative support, which is ultimately an outcome of the local culture and circumstances of Cyprus. Similar evidence can be drawn from many other developing countries in the world (e.g. Rwegasira 2000 on African countries *and* Haniffa and Hudaib 2006 on Malaysia). The findings of these studies show that most developing countries have unique social, cultural, legal and economic characteristics, which do not align with the system of dispersed ownership and the primacy of shareholder advocated in this model.

These variations justify the need to supplement the standard features of the Anglo-Saxon Model of Corporate Governance to suit the context of developing countries. This requires reconceptualising the exiting model of corporate governance to deviate from the traditional corporate governance model, which is based on the agent-principal relationship to a more holistic approach, which considers the relationships that a corporate entity is having with its different stakeholders and the external environment (Senaratne, 2009). Furthermore, these reforms in corporate governance would be productive only if they could be accompanied by reforms in the company law and judicial system *and* changes in the financial markets and related macro-economic variables.

Conclusion

This study examined the corporate governance reforms carried out in Sri Lanka during the period 1997 to 2008 via the introduction of voluntary and mandatory codes on corporate governance best practices. The essential feature of these reforms is that they have been carried out in conformity with the Anglo-Saxon Model of Corporate Governance owing to both historical and

economic factors. However, many concerns have been raised as to the applicability of this model in the Sri Lankan context and thereby on the efficacy of corporate governance reforms that had taken place in the country. This shows that though there are obvious reasons for the developing countries like Sri Lanka to move in the direction of the Anglo-Saxon Model of Corporate Governance, it is not clear whether these reasons are sufficient enough to justify the adoption of this model.

A corporate governance model cannot be seen in isolation from the rest of the institutional underpinning of the economy in question. The corporate governance system of a country is embedded in its unique history, culture, laws and economic environment. Hence, it is necessary to contextualize the corporate governance reforms of a country towards its socio-economic and political environment. This requires adopting political economy perspective in designing corporate governance reforms in a country. This perspective provides a wider conception of the company, its activities *and* impacts upon economy and society, together with some sense of how the wider economy and society impact upon the company in the course of a dynamic co-evolution. Thus, a paradigm shift is required in the existing corporate governance model in Sri Lanka to focus on these various facets of corporate governance.

Corporate governance is not a static concept. It is completely changeable and transformable *and* there is not a universal model that covers all societies, cultures and business situations. Even the market-based (Anglo-Saxon) model and insider-based model will continue to evolve to meet the needs of the ever-changing global economy. Therefore, the corporate governance reforms of a country should be considered from a broader perspective. The core concern of corporate governance reforms should be the contribution of corporate governance towards the growth of corporate entities and thereby to development of a country. Thus, any model of corporate governance desirable for this purpose could be selected or developed by a country.

References

- Aguilera, R.V., Filatotchev, I., Gospel, H. and Jackson, G. (2007). An Organizational Approach to Comparative Corporate Governance: Costs, Contingencies and Complementarities. *Working Paper*.
- Bhattacharyya, A. K. (2004). Issues in Corporate Governance in India. *Good Governance, Democratic Societies and Globalisation* (pp.383-403). Calcutta: SAGE Publications.
- Cadbury, A. (1992). *Report of the Committee on the Financial Aspects of Corporate Governance*, Cadbury Report. London: Gee Publishing London.
- Cadbury, A. (2004). Forward. Claessens, S. (2003). Corporate Governance and Development. Global Corporate Governance Forum, *Focus 1*, Washington: World Bank.
- Central Bank of Sri Lanka. (2002). *Code of Corporate Governance for Banks and Other Financial Institutions*. Colombo: Central Bank.
- Central Bank of Sri Lanka. (2008). *Banking Act Direction No. 01 of 2008 on Corporate Governance for Licensed Commercial Banks*. Retrieved from www.cbsl.lk.
- Central Bank of Sri Lanka. (2008). *Finance Companies (Corporate Governance) Direction, No. 3 of 2008*. Retrieved from www.cbsl.lk.
- Claessens, S., Djankov S. & Lang, L. H. P. (2000). The Separation of Ownership and Control in East Asian Corporations. *Journal of Financial Economics*, 58, 81-112.
- Clark, T. (2004). Introduction: Theories of Governance – Reconceptualizing Corporate Governance Theory after Enron Experience. *Theories of Corporate Governance, The Philosophical Foundations of Corporate Governance*, (pp.1-30). Oxon: Routledge.
- Colombo Stock Exchange. (2010). Listing Rules. Retrieved from www.cse.lk.
- DiMaggio, P.J. & Powell, W.W. (1983). The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organisational Fields. *American Sociological Review*, 48, 146-160.
- Eisenhardt, K. M. (1988). Agency and Institutional Theory Explanations: The Case of Retail Sales Compensation. *Academy of Management Journal*, 31, 488-511.
- Financial Services Authority. (2003). *The Combined Code on Corporate Governance*. London: FSA.
- Gay, K. (2002). Board Theories and Governance Practices: Agents, Stewards and their Evolving Relationships with Stakeholders. *Journal of General Management*, 27(3), 36-61.
- Haniffa, R. and Hudaib, M. (2006). Corporate Governance Structure and Performance of Malaysian Listed Companies. *Journal of Business Finance and Accounting*, 1-29.
- Hampel, R. (1998). *The Final Report of the Committee on Corporate Governance*, Hampel Report. London: Gee Publishing.
- Higgs, D. (2003). *Review of the Role and Responsibilities of Non-executive Directors*. London: Department of Trade and Industry.

- Hillman, A.J., Cannella Jr, A.A., & Paetzold. (2000). The Resource Dependence Role of Corporate Directors: Strategic Adaptation of Board Composition in Response to Environmental Change. *Journal of Management Studies*, 37.
- Hofstede, G. (1994). *Cultures and Organizations*. London: McGraw Hill.
- Johnson, S., La Porta, R., Lopez-de-Silanes, F., & Shleifer, A. (2000). Tunelling. *American Economic Review*, 90 (2), 22-27.
- Jones, C., Hesterly, W.S. and Borgatti, S.P. (1997). A General Theory of Network Governance: Exchange Conditions and Social Mechanisms. *Academy of Management Review*, 22.
- Krambia-Kapardis, M. and Psaros, J. (2006). The Implementation of Corporate Governance Principles in an Emerging Economy: a critique of the situation in Cyprus. *Corporate Governance* 14 (2), 126-139.
- La Porta, R., Lopez-de-Silanes, F. & Schliefer, A. (1999). Corporate Ownership around the World. *Journal of Finance*, 54 (2), 1147-1170.
- OECD. (1999). OECD Principles of Corporate Governance. Paris: OECD.
- Reed, D. (2004a). Corporate Governance Reforms in Developing Countries. *Corporate Governance, Economic Reforms and Development*, (pp.1-24). New Delhi: Oxford University Press.
- Reed, D. (2004b). The Role of Governance in Promoting Development. *Corporate Governance, Economic Reforms and Development* (pp. 249-270). New Delhi: Oxford University Press.
- Rwegasira, K. (2000). Corporate Governance in Emerging Markets: Whither Africa?. *Corporate Governance* 8 (3), 258-267.
- Samarakoon, L. (1999). The Ownership Structure of Sri Lankan Companies. *Sri Lankan Journal of Management*, 4 (3&4), 143-157.
- Securities and Exchange Commission of Sri Lanka. (2004). *Guidelines for Listed Companies in respect of Audit and Audit Committees*. Colombo: SEC.
- Senaratne, S. & Gunaratne & P. S. M. (2007a). Significant Features and Associated Issues of Corporate Governance Practices of Sri Lankan Listed Companies. *Proceedings from International Research Conference on Knowledge for Growth and Development*. Faculty of Management and Finance, University of Colombo, Sri Lanka.
- Senaratne, S. & Gunaratne, P. S. M. (2007b). Ownership Structure and Corporate Governance of Sri Lankan Listed Companies. *Proceedings from Fourth International Conference on Business Management*. Faculty of Management Studies and Commerce, University of Sri Jayewardenepura, Sri Lanka.
- Senaratne, S. & Gunaratne, P. S. M. (2008a). The Anglo-Saxon Approach to Corporate Governance and its applicability to Sri Lanka. *Proceedings from Fifth International Conference on Business Management*. Faculty of Management Studies and Commerce, University of Sri Jayewardenepura, Sri Lanka.
- Senaratne, S. & Gunaratne, P. S. M. (2008b). Corporate Governance Development in Sri Lanka: Prospects and Problems. *Proceedings from International Research Conference on Management*. Faculty of Management and Finance, University of Colombo, Sri Lanka.

- Senaratne, S. (2007). Level of Informativeness of Annual Reports and Corporate Governance: A Study of Sri Lankan Quoted Public Companies. *Unpublished PhD Thesis*. University of Colombo, Sri Lanka.
- Senaratne, S. (2009). Existing Corporate Governance Model in Sri Lanka: The need to Reconceptualise. *Proceedings from International Research Conference on Competitive Management in a Dynamic World*. Faculty of Management and Finance, University of Colombo, Sri Lanka.
- Sheard, P. (1998). Japanese Corporate Governance in Comparative Perspective. *Journal of Economics and Finance, January/February*.
- Smith, R. (2003). *Audit Committees - Combined Code Guidance*. Financial Reporting Council, United Kingdom.
- The Institute of Chartered Accountants in England and Wales. (1999). *Internal Controls: Guidance on Directors on the Combined Code*. Turnbull Committee Report.
- The Institute of Chartered Accountants of Sri Lanka. (2002). *Code of Best Practice on Audit Committees*. Colombo: ICASL.
- The Institute of Chartered Accountants of Sri Lanka. (1997). *Code on Best Practice on matters relating to Financial Aspects of Corporate Governance*. Colombo: ICASL.
- The Institute of Chartered Accountants of Sri Lanka. (2003). *Code of Best Practice on Corporate Governance*. Colombo: ICASL.
- The Institute of Chartered Accountants of Sri Lanka. (2008). *Code of Best Practice on Corporate Governance*. Colombo: ICASL.