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An Evaluation of the Compliance of Sri Lankan Listed Companies with Corporate Governance Principles and Best Practices

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Abstract

This study examines compliance with corporate governance principles and best practices by companies listed on the Colombo Stock Exchange by constructing a novel and comprehensive corporate governance index using a sample of 133 firms in 2009 and 2016. Overall, corporate governance improved during the sample period. Corporate governance also improved across all sub-areas of corporate governance, namely board of directors, shareholders, stakeholders, disclosure and transparency, and CEO and management. Moreover, corporate governance improved across all industries except for healthcare. Telecommunications, hotels, manufacturing, energy, and trading sectors show the largest increases while stores, banking, construction, services, and plantations have the lowest improvements. Services and stores sectors have relatively weaker corporate governance while telecommunications, diversified, banking, hotels, manufacturing, and energy show stronger governance. This study adds to the extant evidence on emerging markets and provides important evidence for policymakers to formulate and strengthen corporate governance in Sri Lanka.

JEL classification: G30, G39, G19

Keywords: Agency Theory, Stakeholder Theory, Corporate Governance Index, Sri Lanka

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1. Introduction

This study examines the corporate governance compliance level among listed companies in Sri Lanka on a comprehensive basis. In addition, this study examines the difference between the level of corporate governance in different sub-dimensions and sectors. Accordingly, this study aims to add to the current knowledge regarding compliance with the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka)'s Code of Best Practice on Corporate Governance, the OECD Principles of Corporate Governance, and the UK Corporate Governance Code, and develop a weighted corporate governance index.

No prior research that uses a comprehensive corporate governance index (CGI) has been observed, and most previous studies consider mainly board-related principles to evaluate corporate governance. Since no composite index in Sri Lanka covers all the required corporate governance dimensions for measuring compliance with corporate governance, evaluating the corporate governance compliance level in Sri Lanka on a comprehensive basis is of paramount importance. As an emerging economy, the need for corporate governance has been emphasized in Sri Lanka following the collapse of several enterprises, including the Central Investment and Finance Ltd. (previously Central Investment and Finance PLC), The Standard Credit Finance Ltd., TKS Finance Ltd., The Finance Company PLC, ETI Finance Ltd., and Swarnamahal Financial Services PLC (Kirinde, 2021). Currently, Sri Lankan companies face corporate governance issues, including the lack of stakeholder consultation in formulating regulations, lack of periodical assessment of the board of directors, and foreign shareholders receiving insufficient notice of general meetings (Ajward & Weerasinghe, 2019). The present study is a pioneering study in Sri Lanka to examine how corporate governance compliance levels changed over time and across industries on an in-depth basis. Moreover, Sri Lanka's 30-year-long civil- war ended in 2009, and this study compares the level of corporate governance in 2009 with that of 2016, highlighting the trend in the corporate governance compliance level in Sri Lanka. Finally, this study provides an in-depth assessment of the compliance level of various sectors, which is useful for regulators and policymakers.

This study entails a comprehensive analysis covering five main corporate governance components: the board of directors, shareholders, stakeholders, the chief executive officers (CEOs) and the management, and transparency and disclosure. A descriptive analysis was performed to determine the corporate governance compliance level, a paired sample t-test was carried out to compare the difference of the level of compliance of corporate governance between 2009 and 2016, and a cross-tabulation was employed to compare the variance in compliance level groups based on the constructed Corporate Governance Index. Next, the one-way Analysis of Variance (ANOVA) test was performed to identify the difference in compliance levels among different industries.

Overall, we find that the corporate governance of listed firms in Sri Lanka has improved during the sample period from 2009 to 2016. The corporate governance index increased from 48.97% in 2009 to 58.18% in 2016, providing evidence of improvement in the overall corporate governance of listed companies in Sri Lanka. The results further show a decrease in the number of companies in the low and lower-middle CGI groups and an increase in the number of companies in the upper-middle and high CGI groups. We also find that corporate governance has improved across all five sub-components of the corporate governance index with the largest improvement in the area of stakeholders and the lowest improvement relating to shareholders. The results also show that corporate governance improved across all industries in the Colombo Stock Exchange except for healthcare. The sectors with the largest improvement in corporate governance are telecommunications, hotels, manufacturing, energy, and trading while the sectors with the lowest increases include stores, banking, construction, services, and plantations. Further, sectors with relatively weaker corporate governance compliance are services and stores and those with stronger compliance include telecommunications, diversified, banking, hotels, manufacturing, and energy.

This paper is organized into five sections. Section 2 reviews the literature on the corporate governance compliance level, while Section 3 discusses the process of constructing a corporate governance index and the methodology of data analysis. Section 4 presents the empirical results including descriptive analysis, classification into compliance groups, the difference in compliance levels among various sectors in Sri Lankan listed companies. Section 5 provides the conclusions of the study.

2. Literature review

2.1 The concept of corporate governance

There are different definitions of corporate governance in the literature. Cadbury (1992) defined corporate governance as “the system by which companies are directed and controlled” (p. 14). This definition is the most common definition for corporate governance. However, this definition considers only the system approach and ignores the relationship approach. Zingales (1998) described corporate governance from a broad perspective as “the set of conditions that shape ex-post bargaining over the quasi-rents generated by the firm” (p. 16). On the other hand, Shleifer and Vishny (1997) defined corporate governance as to how suppliers of finance to corporations assure themselves of a return on their investment, while Gillan and Starks (2011) described corporate governance as the system of laws, rules, and factors that control a company’s operations.

Dissabandara (2010) outlined “corporate governance as the mechanism by which companies are rationalized, directed, controlled, and monitored. Corporate governance relates different stakeholders such as shareholders, directors, managers, employees, creditors, customers, the global environment, and the rest of society with corporate performance and wellbeing by forming a common goal” (p. 7). This definition is considered a broader definition of corporate governance that includes all the components necessary to achieve compliance with corporate governance principles and practices.

2.2 Evolution of codes of corporate governance

The adoption of corporate governance practices has been formalized through the codes of corporate governance. The UK Cadbury Report (1992) was the first corporate governance code globally. The financial crisis in 2009, and the critical losses and failures throughout the UK banking system resulted in the corporate governance review by Sir David Walker, who published the Walker Review in November 2009. The existing UK Combined Code was renamed the UK Corporate Governance Code in 2010. Additionally, revisions were made to the code in 2013, 2014, 2016, and 2018.

The OECD Council updated the Principles of Corporate Governance in 2004 to guide stock exchanges, investors, and corporations to awaken corporate governance globally. The first OECD code consists of five principles: ensuring the basis for a practical corporate governance framework; the rights of shareholders and essential ownership functions; the equitable treatment of shareholders; the role of stakeholders in corporate governance, disclosure, and transparency; and the responsibilities of the board. In 2015, the OECD revised its Corporate Governance Code including provisions related to institutional investors, stock markets, and other intermediaries in line with the changes in the business world (OECD, 2020).

In the Sri Lankan context, the first voluntary Code of Best Practices, introduced by the CA Sri Lanka in 1997, was confined to the financial aspects of corporate governance (Senaratne & Gunaratne, 2008). The code was amended with provisions for an audit committee in 2002. Later, in 2003, the CA Sri Lanka introduced the Code of Best Practice in Corporate Governance. Then, the first mandatory Code of Best Practice on Corporate Governance (2008) was jointly introduced by the CA Sri Lanka and the Securities and Exchange Commission of Sri Lanka (SEC) for listed companies in 2008. Subsequently, the Revised Code of Best Practice on Corporate Governance (2013) was developed to adapt to the changing requirements of the business in 2013. Then, in 2017, the CA Sri Lanka revised its Code of Best Practice on Corporate Governance (2017) by introducing environment, sustainability, and governance (ESG) principles and Internet of Things (IoT) provisions (CA Sri Lanka, 2020).

2.3 Agency theory

Adam Smith initially explained the agency problem in the 18th century, while Ross (1973) further explored this problem. Jensen and Meckling (1976) explained that the principal-agent problem arises due to the separation of ownership and control. “The agency relationship between two parties is defined as the contract between the owners (principals) and the managers or directors (agents)” (Jensen & Mecking, 1976, p. 308). Fama and Jensen (1983), Williamson (1987), and Aghion and Bolton (1992) detailed the theory and this problem over the next two decades, while Hart (1995) also further elaborated the theory.

The agency theory has been developed into two separate streams in the economic literature, namely the positivist agent and the principal-agent theories (Eisenhardt, 1989). Positivist agency theory denotes the conflicting situations due to the different goals that corporate governance mechanisms can reduce. On the other hand, the principal-agent theory concerns the contract between principal and agent (Eisenhardt, 1989). Both these streams of theories consider a common unit of analysis, which is the principal and the agent problem, and share common assumptions related to people, organizations, and information. Nevertheless, these streams differ based on mathematical rigor, dependent variables, and style (Jenson, 1993).

The agency theory is the relationship between shareholders and managers or directors appointed by shareholders who have the authority to run the business on behalf of the shareholders (Jensen & Mecking, 1976). According to Padilla (2002), the managers or directors may not necessarily act in the best interest of shareholders. The separation of ownership and control is the primary reason behind the conflicts between shareholders and management (Aguilera et al., 2008). Furthermore, Hart (1995) emphasized that the dispersion of shareholders results in ineffective monitoring of management by shareholders. Therefore, the shareholders who were unable to conduct required monitoring roles worsened the agency conflicts and the management pursued self-interest objectives at the cost of shareholders. Thus, corporate governance mechanisms relating to the board of directors and shareholders are required to reduce agency problems.

2.4 Stakeholder theory

Freeman and Reed (1983) argued that the stakeholder theory inherent in the management discipline can be used to understand the functions of the board of directors. According to Freeman (1984, p. 6), stakeholders are "any group or individual who can affect or is affected by the achievement of the corporation's purpose." Therefore, stakeholders include a large group of participants who have a direct or indirect stake in the business (Carroll et al., 2018). In addition, Solomon and Solomon (2004) stated that stakeholders include shareholders, employees, suppliers, customers, creditors, the public, and communities in the vicinity of the company's operations.

Wheeler and Sillanpaa (1997) further elaborated those stakeholders include investors (including banks), managers, employees, customers, business partners (suppliers and subsidiaries), local communities, civil society (including regulators and pressure groups), and that the natural environment should be taken into consideration in the governance structure. The relationship between the company and its internal stakeholders (employees, managers, and owners) is framed by formal and informal rules. The stakeholder theory supports the contention that "companies and society are interdependent. Hence, the corporation serves a broader social purpose beyond its responsibilities to shareholders" (Kiel & Nicholson, 2003, p. 31).

According to Donaldson and Preston (1995), the stakeholder theory is a collection of theories for managing stakeholders rather than a single theory. Moreover, Friedman and Miles (2002) divide the theory into three approaches: (1) the descriptive (which explains how the organization operates in terms of stakeholder management); (2) the instrumental (which shows how to achieve organizational goals through stakeholder management); and (3) the normative (which explains how businesses should operate, particularly in terms of moral principles). Normative stakeholder theory draws on ethical principles to propose stakeholder-centered responses to corporate governance issues (Hendry, 2001). The impact of business activities on all identifiable stakeholders is the subject of the stakeholder theory of corporate governance. In the governance process, corporate management (officers and directors) should consider the interests of each stakeholder according to this approach. This includes attempting to minimize or eliminate conflicts between stakeholder interests. It further considers the interests of any third party who is reliant on the corporation in some way, in addition to the typical members of the organization (officers, directors, and shareholders). The provisions related to the shareholder and stakeholder rights must be provided to meet the expectations of the stakeholder theory.

2.5 Empirical studies on compliance with corporate governance indices (CGIs)

2.5.1 Literature related to developed markets

Gompers et al. (2003) developed a CGI in the U.S. using 24 provisions under five groups, namely tactics for delaying hostile bidders (Delay), voting rights (Voting), director/officer protection (Protection), other takeover defenses (Other), and state laws (State). This study used the

Investor Responsibility Research Centre (IRRC) database to construct an equally weighted CGI known as the GIM Index which includes internal and external corporate governance mechanisms. This study found that, in the U.S., the mean corporate governance compliance level was 37.5% from 1990 to 1998 with variation across different provisions. Various scholars have applied this methodology to construct CGIs and used the GIM Index in their work (Bianco et al., 2007; Jo & Harjoto, 2012). Nevertheless, in the Sri Lankan context, external level corporate governance mechanisms are not standardized since the stock market is small. Furthermore, Sri Lanka does not have a corporate governance database to construct CGIs.

In the UK, corporate governance indices are constructed using compliance with corporate governance codes (Pass, 2006; Hegazy & Hegazy, 2010). Pass (2006) has surveyed 50 companies and found that 35% of the UK firms complied fully with the 2003 UK Combined Code. Moreover, Pass indicated that 45% of firms have taken actions to comply with the code or suggested acceptable explanations for non-compliance. In addition, Hegazy and Hegazy (2010) reported a 70% compliance level with the 2003 Combined Code among UK firms in 2008. Using data from 130 UK-listed non-financial firms from 2003 to 2009, Hussainey and Al-Najjar (2012) observed a high Corporate Governance Quotient (CGQ) index that indicated a higher compliance level.

Drobetz et al. (2004) constructed a broad unweighted governance rating for German companies to measure corporate governance compliance level using a questionnaire survey comprising 30 Likert scale questions. The main dimensions in the index include corporate governance commitment, shareholder rights, transparency, management, supervisory board matters, and auditing, and the index was constructed according to the German Corporate Governance Code (GCGC) requirements. The average compliance level in Germany was 64.3% and varied across different sectors. This study adopted the GCGC rules that include the requirement of two-tiered boards. However, the code cannot be directly applied in Sri Lanka which follows a model of unitary board structure.

In the Japanese context, in one of the pioneering studies conducted by Dissabandara (2006), it was found that the Japanese Corporate Governance Quotient (JCGQ) was 45% in 2004. This study constructed a comprehensive corporate governance measurement including the main dimensions of the role of the board of directors and committees, leadership responsibility of CEO, setting fairness and transparency for executive management, reporting to the shareholders, and communicating with investors. This study conducted an in-depth investigation of corporate governance compliance in Japan, including classification of High JCGQ companies, Low JCGQ companies, and considered the traditional Japanese CG system, intermediate CG system, and newly proposed Anglo-Saxon type committee System in Japan as well.

Furthermore, Allegrini and Greco (2013) found an increased compliance level of governance practices and voluntary disclosure based on a CGI constructed according to the 60 corporate governance provisions of the 2007 Italian Civil Governance Code using annual reports of Italian listed companies. Similarly, Salterio et al. (2013) found that, on average, 82% of the firms complied with some of the recommended good corporate governance practices.

The literature on developed markets suggests that the corporate governance index is mainly constructed based on country-specific codes. Some authors used the corporate governance ratings published by the IRRC, Institutional Shareholder Services (ISS), and the S&P Rating Services as corporate governance measures. Moreover, corporate governance indices include internal and external governance provisions. Finally, these studies suggest a higher level of corporate governance in most developed economies.

2.5.2 Literature related to emerging markets

The wide disparity in compliance with corporate governance disclosure is observed in developing countries (Klapper & Love, 2004; Black et al., 2014). Qu and Leung (2006), using a CGI constructed from secondary data collected from 120 Chinese listed firms in 2003, identified more compliance related to stakeholder interest and zero compliance concerning the related party transactions. With a different methodology, Tang et al. (2011) constructed an equally weighted CGI using five main sub-components, including expropriation of minority interests, the board of directors' structure and process, supervisory board structure and process, ownership structure, and financial transparency and disclosure by adopting the methodology of Bai et al. (2004). They found an average CGI of 46%. However, these two indices ignore the stakeholder component of CGI and do not consider the external mechanisms of corporate governance.

In Korea, Black et al. (2006a) constructed an equally weighted Korean Corporate Governance Index based on a survey of 515 firms in the Korean Stock Exchange in 2001. The index was constructed based on five main sub-elements: minority shareholders' rights, shareholder rights, board structure, board procedure, disclosure, and ownership parity. They found a mean value of 32.63% in Korea for the CGI. Furthermore, Black et al. (2006b) constructed a CGI in 2006 using small and large firms in Korea and found mean compliance of is 29.21 for small firms and 51.82 for large firms, suggesting low compliance by smaller firms relative to large firms.

A weighted CGI was constructed in Hong Kong by Cheung et al. (2007) in 2007 based on the Revised OECD Principles of Corporate Governance and the Code of Best Practices of the Hong Kong Exchanges and Clearing Limited. This study used 86 criteria including the rights of shareholders, the role of stakeholders, disclosure, and transparency, and board responsibilities and composition. The average compliance level of corporate governance was 48.33%. Moreover, higher compliance levels were observed for the role of stakeholders, responsibilities, and composition of the board while the lowest level was observed in shareholders' rights.

The CGI methodology applied by Cheung et al. (2007) was adopted by Cheung et al. (2008) in China, and an equally weighted CGI was constructed for 89 large listed companies. The study found that the Chinese companies improved their compliance level with governance reforms and that overseas-listed Chinese companies have a higher compliance level related to stakeholders' role, disclosure, and transparency than non-overseas-listed Chinese companies.

In the Indian context, Haldar and Rao (2014) constructed a CGI for 323 Indian listed companies using secondary data with the main elements including the board of directors index, the audit committee index, the shareholder's grievance committee index, the remuneration committee index, the nomination committee index, and the disclosure practices index. Subsequently, an increase in the level of corporate governance in India was observed (Haldar & Rao, 2014). In 2006, Satnalika and Rao (2016) constructed an equally weighted CGI using 11 criteria, including ownership structure, the board size, board independence, independent chairman, CEO duality, audit committee, nomination committee, remuneration, shareholder's grievance, disclosures, and transparency. The study found that the average compliance level in India was 65.74% and highlighted the upward trend of increasing corporate governance compliance levels.

Furthermore, Gulati et al. (2020) constructed a weighted CGI in 2020 using 40 Indian banks with sub-dimensional indices including board effectiveness, audit function, risk management, remuneration, shareholder rights and information, and disclosure and transparency. This study used data envelopment techniques to construct weights for the CGI sub-indices and observed higher-level corporate governance in Indian banks. In Bangladesh, Haque et al. (2011) and Haque and Arun (2016) constructed CGIs using non-financial listed firms by following the methods of Klapper and Love (2004) and Black (2001). The findings of Haque et al. (2011) found that the average compliance level of 101 non-financial firms in Bangladesh is 40.84%.

In the Sri Lankan context, Dissabandara (2010) constructed a comprehensive Board Index and evaluated 59 listed companies from 2006 to 2010 and found that the compliance level relating to board performance varied significantly among companies. This board index included 14 main areas, including determining future direction, policy formulating practices, engagement in strategic thinking and planning, board structure and practices, board meetings, board membership and orientation, board committees, board-CEO and senior management relationship, board-staff roles, monitoring and evaluation practices, legal and ethical compliance, the entity, and stakeholders and external relations practices. Using a sample of 157 listed companies, Manawaduge (2012) reported that the compliance level of Sri Lankan companies varied significantly and found the variations to be directly related to the ownership structure of companies, and this study pointed out that corporate governance practices varied from 48% to 61% across sectors.

In summary, the literature on emerging markets suggests an average compliance level of corporate governance. It also was highlighted that there is no comprehensive index to measure the corporate governance level in Sri Lanka.

3. Methodology

3.1 Sample and data

A total of 287 companies had been listed on the Colombo Stock Exchange (CSE) as of December 31, 2015. This study selected companies listed as of December 31, 2009, and continued to be listed until December 31, 2015. The motivation to use 2009 as the starting year is that it marked the end of the Sri Lankan civil war and the SEC, and the CA Sri Lanka jointly introduced the Corporate Governance Code in 2008 with the mandatory requirements to the listed companies. Using stratified sampling to ensure representation across the 19 industry sectors of the CSE, we initially selected 150 firms with the highest market capitalization in each sector as of December 31, 2015. However, 29 companies with no common listing status in 2009 and 2016 were dropped. Finally, the final sample was identified with at least five companies from sectors that comprise more than five companies to represent individual sectors. In addition, the sectors that comprise less than five (e.g., the telecommunication sector had two companies listed) were also selected for the representation of the sectors. The final sample includes 133 firms (see Table 1).

To collect the data, we prepared a corporate governance checklist that includes 132 criteria (see Table 2) by reference to the corporate governance practices of the Code of Best Practice on Corporate Governance 2013, the OECD Principles of Corporate Governance (2015), and the UK

Corporate Governance Code (2016). The corporate governance information was collected using a content analysis of the annual reports and articles of association of firms.

3.2 Corporate Governance Index (CGI)

The main objective of this study is to examine the corporate governance compliance level in Sri Lanka by constructing a comprehensive corporate governance index. As shown in Table 2, the CGI comprises five sub-indices: shareholders (SH); stakeholders (ST); disclosure and transparency (DI); the board of directors (BO); and the CEO and management (CEO).

Table 1

The Sample of the Study

Sector	No. of Companies in CSE	Final Sample	Representation from the total population (%)
Bank Finance and Insurance	60	22	36.67
Beverage Food and Tobacco	21	14	66.67
Chemicals and Pharmaceuticals	10	5	50.00
Construction and Engineering	4	2	50.00
Diversified Holdings	19	11	57.89
Footwear and Textiles	3	0	00.00
Health Care	6	5	83.33
Hotels and Travels	37	15	40.54
Information and Technology	2	0	00.00
Investments	9	5	55.56
Land and Property	19	7	36.84
Manufacturing	37	16	43.24
Motors	6	3	50.00
Oil Palms	5	5	100.00
Plantations	19	5	26.32
Power and Energy	8	4	50.00
Services	8	3	37.50
Stores Supplies	4	4	100.00
Telecommunication	2	2	100.00
Trading	8	5	62.50
	287	133	46.34

Source: CSE (2015)

Table 2

Sub-Indices of the Corporate Governance Index

Sub-Index	Criteria
Board of Directors (BO)	80
Shareholders (SH)	21
Stakeholders (ST)	07
Disclosure and transparency (DI)	16
CEO and Management (CEO)	08
Total components (CGI)	132

The shareholders' sub-index consists of shareholder rights, communication, and engagement practices (Black et al., 2020; Saygili et al., 2020). The stakeholders' sub-index consists of practices related to stakeholder rights, communication, and engagement practices (Cheung & Jang, 2008; Saygili et al., 2020). The disclosure and transparency sub-index measures provisions related to the quality of disclosure, audit disclosure, communication channels, and sustainable reporting (Matić & Papac, 2014; Nerantzidis, 2016). The board of directors sub-index includes practices related to board structure, board committees, and board accountability (Khan & Banerji, 2016; Dissanayake et al., 2018; Al-Smadi, 2019). Finally, the CEO and management sub-index uses practices related to the appointment and performance evaluation of CEOs and executive management, compliance function, and business resilience (Matić & Papac, 2014; Satnalika & Rao, 2016). The extant literature and expert opinions of five professionals and academics were consulted to identify the relative importance of various governance dimensions (Dissabandara, 2006; Nerantzidis, 2018), and accordingly, the weights of sub-indices are 8% (SH), 11% (ST), 11% (DI), 55% (BO), and 12% (CEO).

Each of the 132 criteria was scored on a 1 to 5 Likert scale based on the information contained in annual reports of firms in 2009 and 2016. The scores were allocated as follows: Full compliance (5), greater than partial compliance (4), partial compliance (3), below-average compliance (2), minimal compliance (1), and complete non-compliance (0). This is consistent with Fuenzalida et al. (2013) and Islam et al. (2015).

The final CGI value was determined using the weighted average formula below. Each sub-index value is calculated by applying the Likert scale approach for each criterion separately.

$$CGI_j = \sum_{i=1}^{n} \{(W_{iSH} \times SH_j) + (W_{iST} \times ST_j) + (W_{iDI} \times DI_j) + (W_{iBO} \times BO_j) + (W_{iCEO} \times CEO_j)\}$$

where,

CGI_j = Total CGI for firm j

W_i = The average weights assigned to criterion *i*

SH_j = Total shareholder rights and responsibilities index value for firm j

ST_j = Total stakeholders index value for firm j

DI_j = Total disclosure and transparency index value for firm j

BO_j = Total board of directors' index value for firm j

CEO_j = Total CEO and executive management index value for firm j

n is the number of firms. The sum of all weights across firms equals one hundred. Initially, the CGI is calculated for individual companies with the content analysis of the respective companies. Next, the overall CGI is computed by aggregating the CGIs of individual companies. This approach provides an index value for each company and an aggregate index that varies from zero to one hundred. The following section explains the analysis based on the constructed CGI for 133 companies in 2009 and 2016.

4. Results

4.1 Descriptive statistics

Table 3 presents the descriptive statistics of the CGI and its components for 2009 and 2016. Accordingly, the mean value of the CGI is 58.18 in 2016, which has increased by about eight parentage points from 48.97 in 2009. When considering individual firms, the maximum score of CGI was 78.80 in 2009 while the minimum score of CGI was 18.59 in 2009. In 2016, the maximum score of CGI was 87.19, while the minimum score of CGI was 32.54. These scores exhibited an improvement of CGI in the 2009-2016 period. These results are consistent with those of previous studies conducted in other emerging markets such as Pakistan (2017: 53.00) and Jordan (2016: 50.00), higher than India (2001-2016: 42.72) and Bangladesh (2015-2017: 45.34), and lower than China (2016: 62.49) (Li, 2018; Al-Smadi, 2019; Srivastava, Das, & Pattanayak, 2019; Tahir et al., 2019; Rouf & Akhtaruddin, 2020).

When considering sub-indices, the mean value of shareholders is 48.47, stakeholders is 36.59, disclosure is 70.61, board of directors is 49.87, and CEO and executive management is 41.79 in the year 2009. In 2016, the mean value of shareholders is 53.67, stakeholders is 62.32, disclosure is 79.05, and CEO and executive management is 53.31. Thus, this study finds evidence of improvements in all the CGI sub-indices by at least 10% from the year 2009 to 2016. In terms of the descending order of increase, the sub-indices rank stakeholders, CEO, disclosure, board of directors, and shareholders. There is a 70% increase in the compliance level of the stakeholder sub-index in 2016 compared with 2009. This may be due to the sustainability reporting corporate governance practice in corporate governance code 2013. In addition, the CEO and management sub-index increased by 27% in the 2009-2016 period. Figure 01 shows the behavior of the CGI and sub-indices in 2009 and 2016.

Table 3

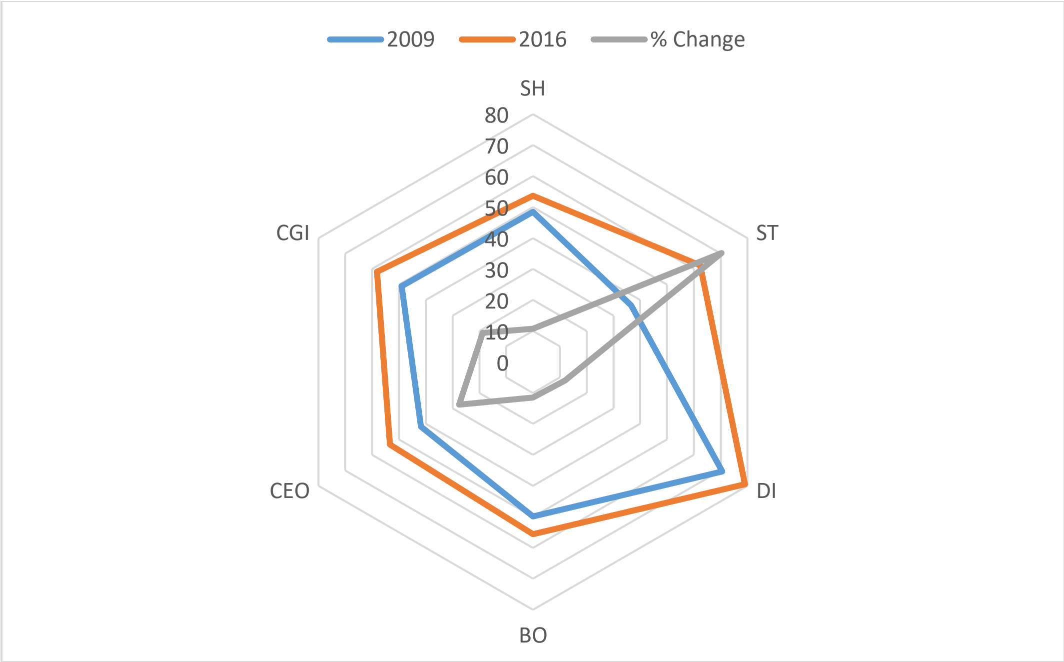
Descriptive Statistics for CGI and Sub-Indices

Index	Year	Mean	Minimum	Maximum	Standard Deviation
CGI	2009	48.97	18.59	78.80	12.45
	2016	58.18	32.54	87.19	13.32
SH	2009	48.47	0.00	84.76	1.70
	2016	53.67	42.86	84.76	1.84
ST	2009	36.59	0.00	100.00	2.82
	2016	62.32	0.00	100.00	2.90
DI	2009	70.61	3.90	93.75	1.81
	2016	79.05	31.25	100.00	1.50
BO	2009	49.87	3.90	84.94	8.29
	2016	55.60	43.75	93.75	8.68
CEO	2009	41.79	0.00	75.00	3.24
	2016	53.31	12.50	87.50	2.90

Note. SH is Shareholders, ST is Stakeholders, DI is Transparency and Disclosure, BO is Board of Directors, CEO is Chief Executive Manager and Executive Management, and CGI is Corporate Governance Index.

Figure 1

Corporate Governance Index and Sub-Indices



Note. SH is Shareholders, ST is Stakeholders, DI is Transparency and Disclosure, BO is Board of Directors, CEO is Chief Executive Officer and Management, and CGI is Corporate Governance Index.

A paired sample t-test was conducted to compare CGI in 2009 and 2016. A significant difference was evident in CGI of 2009 ($M = 48.973$, $SD = 12.454$) and 2016 ($M = 58.179$, $SD = 13.318$, $t(132) = -0.755$, $p = 0.005$). These findings further confirm a statistically significant mean difference in CGI between 2009 and 2016.

4.2 Classification of firms by compliance level

Based on the calculated CGI in 2009 and 2016, firms were classified according to the compliance level of CGI into four compliance groups as low (0 – 40), lower-middle (41- 60), upper-middle (61- 80), and high (81-100). The results are given in Table 4.

In 2009, 33 companies had low (0-40) CGI scores while 14 companies scored low in 2016, illustrating a 58% decrease in the number of firms in the low compliance category. In 2009, there were 72 firms in the lower-middle compliance group (41-60), and this number declined to 62 in 2016. Additionally, the number of firms in the upper-middle group increased significantly from 25 in 2009 to 46 in 2016. Further, firms in the high compliance category (80-100) increased from three in 2009 to ten in 2016. Thus, the results again show clear evidence of improvements in corporate governance of Sri Lankan firms from 2009 to 2016.

Table 4

Classification of Compliance Level of Firms

CGI groups	**Year**	
	2009	2016
Low (0-40)	33	14
Lower-middle (41-60)	72	63
Upper-middle (61-80)	25	46
High (81-100)	3	10
Total	133	133

4.3 Sectoral comparison of CGI

We also examine the distribution of the CGI across the 19 sectors of the CSE. The results are provided in Table 5. In 2009, corporate governance compliance was weak (less than 40%) in services (24.14%), stores (36.67%), trading (36.03%), and services (39.45%) sectors. In contrast, corporate governance compliance was high (greater than 60%) in banking (62.79%) and diversified (60.62%) sectors. In 2016, a weak compliance level is only observed in services (27.09%) and stores (37.41%) sectors. In contrast, stronger compliance is observed in six sectors: Telecommunications (79.84%), diversified (68.97%), banking (65.25%), hotels (64.55%), manufacturing (62.79) and energy (61.78%). The telecommunication sector included only two large companies exhibiting a high index value in 2016 and a significant increase in compliance level compared with 2009 mainly due to the high competition in an oligopolistic industry.

Table 5

Sectoral Distribution of the Corporate Governance Index

Sector	2009				2016			
	Mean	Minimum	Maximum	Mean Rank	Mean	Minimum	Maximum	Mean Rank
Banking	62.79	48.25	76.25	1	65.25	52.36	84.40	3
Diversified	60.62	39.11	83.03	2	68.97	45.53	87.19	2
Beverage	54.46	39.11	60.89	3	57.15	45.53	69.97	8
Telecommunication	51.65	49.14	54.16	4	79.85	79.02	80.67	1
Chemicals	51.46	39.59	71.10	5	58.93	39.59	85.27	7
Construction	50.93	60.89	60.89	6	53.43	69.97	69.97	12
Plantations	49.59	39.11	53.14	7	54.01	45.53	59.21	11
Investments	49.19	39.38	51.64	8	56.94	45.53	59.79	9
Energy	48.30	48.30	48.30	9	61.78	61.78	61.78	6
Motors	48.15	30.31	64.71	10	55.76	37.81	72.21	10
Healthcare	46.88	46.88	46.88	11	46.88	46.88	46.88	15
Hotels	46.22	45.60	54.94	12	64.55	64.55	64.55	4
Manufacturing	46.18	38.03	81.10	13	62.79	53.14	83.77	5
Oil palm	40.01	39.11	43.61	14	45.53	45.53	45.53	16
Land	39.45	30.31	51.64	15	47.23	37.81	59.79	14
Stores	36.67	35.70	39.59	16	37.41	35.70	42.56	17
Trading	36.03	31.01	46.99	17	47.24	32.30	80.67	13
Services	24.14	18.59	32.22	18	27.09	20.45	32.22	18

Overall, corporate governance has improved across all sectors except for healthcare where it did not change. The sectors with the largest increase in the corporate governance index are telecommunications, hotels, manufacturing, energy, and trading. The sectors with the lowest increases include stores, banking, construction, services, and plantations.

This study also suggests a wide disparity of CGI in different sectors in Sri Lanka, which is consistent with empirical findings in emerging economies, including Bangladesh (Bhuiyan & Biswas, 2007) and developed economies such as Japan (Dissabandara 2006). In addition, Dissabandara (2010) had also noted a significant disparity of compliance level of board governance across different sectors in Sri Lanka. On the other hand, Li (2018) suggests that the level of disparity of compliance level of corporate governance among sectors is at a consistent level (60-65) in Chinese listed companies.

5. Conclusions

This study examines the extent of the compliance of Sri Lankan listed firms with corporate governance principles and practices by constructing a corporate governance index through a content analysis of annual reports of 133 companies. A coding schedule was created to assess the compliance with the Code of Best Practice on Corporate Governance (2013), the OECD Principles of Corporate Governance (2015), and the UK Corporate Governance Code (2016). Accordingly, a weighted corporate governance index was constructed by examining 132 separate corporate governance provisions in a sample of 133 companies in 2009 and 2016. This study contributes to the literature by developing a comprehensive CGI based on an extensive corporate governance compliance database constructed using a content analysis of annual reports enabling estimation and evaluation of the corporate governance compliance levels of listed companies and industries.

Overall, the corporate governance of listed firms in Sri Lanka has improved during the sample period. The corporate governance index increased from 48.97% in 2009 to 58.18% in 2016 providing evidence of improvement in the overall corporate governance of listed companies in Sri Lanka. These results are broadly consistent with the extant literature in emerging economies such as India, Bangladesh, Pakistan, and China. Moreover, the results of the study further showed a decrease in the number of companies in the low and lower-middle CGI groups and an increase in the number of companies in the upper-middle and high CGI groups. Interestingly, corporate governance has improved across all five sub-components of the corporate governance index. In terms of the descending order of improvement, the sub-indices rank stakeholders, CEO, disclosure, board of directors, and shareholders.

Corporate governance has also improved across all industries in the Colombo Stock Exchange (CSE) except for healthcare where it stayed the same. The sectors with the largest improvement in corporate governance are telecommunications, hotels, manufacturing, energy, and trading while the sectors with the lowest increases include stores, banking, construction, services, and plantations. Further, sectors with relatively weaker corporate governance compliance are services and stores and those with stronger compliance include telecommunications, diversified, banking, hotels, manufacturing, and energy.

The findings of this study will assist policymakers in formulating policies to improve corporate governance in Sri Lanka. The Security Exchange Commission (SEC) and the CSE could consider introducing mandatory policies to improve corporate governance in the areas of shareholder rights, stakeholder rights, and stakeholder engagement which were found to be areas of weak compliance.

In addition, the Institute of Directors could arrange training programs for directors, company officers, and various stakeholders on corporate governance principles and practices to increase awareness and facilitate further development of standards and compliance. Improvements in corporate governance standards and compliance will increase the confidence of both domestic and foreign investors in the capital market of Sri Lanka.

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