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 the extent of compliance of corporate governance reporting practices by the Sri Lankan listed companies using a cross-sectional quantitative analysis of 133 companies encompassing 20 sectors. A comprehensive weighted corporate governance index (CGI), utilizing 132 criteria derived from corporate governance codes of the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka), Organization for Economic Co-operation and Development (OECD), and the UK, was used to evaluate compliance. The findings indicate that the average compliance level of these companies is 58.17 percent, and overall, the extent of governance disclosure varies across the 20 sectors. The lowest disclosures are related to information on stakeholders, and the highest compliance is level with the general disclosures on corporate governance. While the comprehensive Corporate Governance Index developed in this study could be used by other emerging countries to measure compliance levels, the study contributes new knowledge that supports agency theory and stakeholder theory prepositions. These findings are expected to benefit the regulators in Sri Lanka on corporate governance disclosure requirements and sheds insights on the best practices adopted in Sri Lanka with the international business community, especially concerning the areas such as the ease of doing business in Sri Lanka.

Keywords: *corporate governance index, agency theory, stakeholder theory, board of directors*

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1. Introduction

This paper examines the level of corporate governance (CG) compliance in an emerging economy, i.e., in the Sri Lankan setting. The concept of governance has evolved, and many crises have arisen in business regarding the separation of ownership and control (Berle & Means, 1932). Corporate failures in the world, including Polly Peck International (PPI) and Maxwell scandals in the United Kingdom, Enron and WorldCom in the USA, Parmalat, Skandia, and other scandals in Europe, resulted in increased attention on corporate governance in the developed economies and introduction of corporate governance codes such as Cadbury report, Sarbanes Oxley Act, and OECD code (Tricker, 2015). In the South Asian context, Satyam Computer Services in India heightened the attention on corporate governance in emerging economies (Dallas, 2011).

Empirical evidence from developed economies suggests that compliance with corporate governance principles is higher in such economies than in developing economies (Conyon & Mallin, 1997; Cromme, 2005; Hegazy & Hegazy, 2010). Conyon and Mallin (1997) identified an increase in compliance with the corporate governance code in the UK (for instance, 57 percent complied with the CEO duality principle before the implementation and 77 percent after the implementation) via a survey conducted among the UK firms in between 1988-1993. Moreover, this study revealed that a 50 percent increase in compliance of operating board sub-committees was observed during the study period. In addition, Germany observed a higher level of compliance (75 percent) with sound corporate governance principles in the German Governance Code in 2003 (Cromme, 2005). Hegazy and Hegazy (2010) reported a 70 percent compliance with the 2003 Combined Code among the UK firms. Recently, based on data from 1203 USA-listed firms from 2002 to 2014, Guney et al. (2020) observed that a high Corporate Governance Index indicates a higher level of compliance in the USA. Dissabandara (2005) found that the actual CG practices considerably deviate from the expected standard considering the Japanese context. In particular, the role of the board of directors and its performance can be seen as the weakest area of Japanese CG. On average. CG practices of Japanese companies did not significantly change during 2002-2003. However, there is an extensive variation in CG practices across firms. The companies which move for better CG were able to achieve better performance. The significantly higher capital efficiency ratio indicates the greater capital efficiency of high CGI companies.

Black et al. (2020) found that the average level of compliance in India is 59.17, with a wide variation (Minimum: 24.6 ; Maximum: 86.9) and the upward trend of CG compliance. Arslan and Zaman (2015) found that corporate governance in Pakistan is 61.22 on average using 100 companies listed in the Karachi Stock

Exchange. In Bangladesh, Haque et al. (2011) constructed a CGI using non-financial listed firms, following methods adopted by Klapper & Love (2002) and Black (2001). Haque et al. (2011) suggested that the average compliance level of 101 non-financial firms in Bangladesh is 40.84, and a wide variation between the sectors is observable.

In Sri Lanka, Dissabandara (2012) constructed the Board Index, using a sample of 59 companies listed during the period between 2006-2010, and reported that the level of compliance relating to board performance varied significantly among companies using a composite governance score and found that such variations are directly related to the sector. This study highlighted that CG practices varied across sectors from 48 to 61 percent. In a study using a sample of 157 listed companies, Manawaduge (2012) reported that the level of compliance by Sri Lankan companies varied significantly, identifying such variations to be directly related to the ownership structure of companies.

The empirical evidence suggests that the level of compliance of corporate governance practices in some countries is measured using constructed corporate governance indices. However, in the Sri Lankan context, corporate governance has not been observed using a comprehensive index.

Therefore, this study contributes to the literature as follows. Initially, a comprehensive index is constructed, which will help measure the level of corporate governance compliance and an extension and expansion of the Board Index prepared by Dissabandara (2012). Second, this study would provide an essential in-depth analysis of the compliance of corporate governance in Sri Lanka, including an industrial sector-wise analysis. Accordingly, this study entails a comprehensive analysis covering five main components of corporate governance to be consisting of the board of directors, shareholders, stakeholders, the chief executive officer and management and on information and disclosure.

2. Methodology

The research employs a positivist paradigm, deductive reasoning, and a quantitative approach since the positivist approach considers social phenomena that involve facts or causes and effects. This study used quantitative data as rigor needs to be applied in ensuring the accuracy of the measurement (Collis & Hussey, 2013). A sample of 133 listed companies was selected based on the highest market capitalization (sector-wise) as of December 31, 2015. The data for the study was collected using secondary data sources. This study considered the year 2016 as a turning point of the corporate governance mechanisms in Sri Lanka due to two reasons. First, there were some changes in the political environment of the country. Then, governmental policies encouraged improving corporate governance and initiated considerable corporate governance reforms just before this period. Furthermore, the introduction of corporate governance codes such as G20/OECD Principles of Corporate Governance (2015) by the OECD Council and the G20 Leaders' Summit and Code of Best Practice on Corporate Governance (2013) by CA Sri Lanka and the Securities and Exchange Commission Sri Lanka (SEC) in the national and international context took place during this time.

The Corporate Governance Index (CGI) constructed in this study includes 132 different compliance criteria, which were extracted from OECD Principles of Corporate Governance (OECD, 2004), CA Sri Lanka Code (2013), and UK Code (2016). These criteria were then classified into five categories: namely, shareholders (*SH*), the role of stakeholders (*ST*), disclosure and transparency (*DI*), responsibilities of the Board of Directors (*BO*), and Chief Executive Officer and Management (CEO). The five main criteria were weighted according to five experts and validated by an extant literature survey. The weights of sub-indexes include *SH* (.14), *ST* (.8), *DI* (.11), *BO* (.55), and CEO (.12). Scores for 132 items on a scale of 0 to 5 were assigned depending on whether firms had satisfactorily implemented each corporate governance principles/practices through a content analysis on Annual reports. Subsequently, the item scores under each sub-index were divided by the maximum possible scores and multiplied by the weight. The main CGI and sub-indices could range from 0 to 100 for each company.

Data were initially subjected to the data screening and cleaning processes, including subjecting them to a winzorizing process. Afterwards, a descriptive analysis was conducted with the CGI and sub-indices and a sectorial analysis using a high-moderate-low analysis. Finally, a one-way analysis of variance (one-way ANOVA) using Tukey's HSD post hoc test was conducted to determine if there were differences in the total CGI among different sectors.

3. Results

As illustrated in Table 1, overall CGI (M = 58.17) is little above the midpoint of the index. Compared with other emerging countries, the level of CGI is higher than Bangladesh (45.59) and Korea (33.93), but lower than India (59.17), Pakistan (61.22), and Brazil (60.92) (Arslan & Zaman, 2015; Haque et al. 2011; Black et al., 2020). The disparity in corporate governance compliance in Sri Lanka (Min = 32.54, Max = 78.82, SD = 12.25) was similar to that of Korea (Min = 7.9, Max = 88.33) (Black et al., 2020). The transparency dimension indicated by *DI* exhibited the highest score (79) compared to other sub-indexes, indicating that the Sri Lankan companies complied with disclosure requirements due to the mandatory requirements of the SEC. Except for *DI*, all other sub-indexes scored lower than 60 percent. A second higher level of compliance was observed with the score of ST

(62) that represents stakeholders. However, the lowest score of sub-indexes is the CEO which stands for Chief Executive Officer and Executive Management (53); the highest standard deviation with the BO stands for Board of Directors, whereas the lowest standard deviation is with *DI*.

Table 1: Descriptive Statistics of CGI and Sub Indexes in the Year 2016

Variable	Mean	Minimum	Maximum	Standard Deviation
SH	53.305	42.857	84.762	1.837
ST	62.320	0.000	100.000	2.890
DI	79.051	43.750	93.750	1.498
BO	55.860	32.727	84.935	9.012
CEO	53.665	12.500	75.000	2.953
CGI	58.179	32.539	78.802	12.250

Table 2: Sector Comparisons

Panel A: Sectoral Compliance		**Exhibit B: Sectoral Differences** *(Tukey's HSD Post Hoc test (p < .05))*
High	**Mean**	• Bank and Stores Sector and Service
Telecommunication	79.845	• Beverage and Services
Diversified	68.973	• Chemical and Health Care, Land Sector, Oil Palms, Motors, Stores, Services, Plantation, Trade
Banking	65.252	• Construction and Stores Sector, Services
		• Diversified and Healthcare, Plantation, Land, Motors, Stores, Services, Trade
		• Energy and Services, Stores
Low	**Mean**	• Healthcare And Chemicals, Diversified, Telecommunication
Oil palm	45.533	• Hotels And Land, Motors, Plantations, Services
Stores	37.411	• Investment And Service
Services	27.091	• Manufacturing And Services, Stores

Under the high-moderate-low CGI analysis, companies were classified into firms with high, moderate, and low compliance levels, and accordingly, four groups were formed: CGI within the range of 20-40, 40-60, 60-80, and the 80-100. Based on this grouping, in 2016, 14 companies scored within the 40-60 CGI range; 62 companies scored within the 40-60 range, 46 companies scored within the 60-80 range and 11 companies scored more than 80. According to Dissabandara

(2012), there were ten companies in 2006-2010 with low Board of Directors (BO) compliance score in the sample of 59 companies (17 percent), while in this study, there were 14 companies from 133 companies in 2016 (10 percent). This is an indication of the decrease in the companies which exhibit lower-level corporate governance in 2016. Among the higher compliance level companies, Dissabandara (2012) identified nine firms (15 percent of the sample). This increased to 57 companies in this study (2016), which was 42 percent. This exhibits an increase in the level compliance of companies in Sri Lanka. Accordingly, this exhibits an improvement of corporate governance in the 2008-2016 period.

In an analysis of sectorial compliance levels in 2016, the telecommunication sector included only two giant companies exhibiting a high index value (Table 2, Panel A). This was mainly due to the high competition in an oligopolistic situation in the Sri Lankan context. Further, it is observed that in 2016, there was a low compliance level in the service, stores and oil palm sectors. According to the empirical findings of Dissabandara (2012), the CGI Score based on Board Components, the banking sector recorded a higher CGI score, and in 2016, based on our findings, the highest CGI was recorded in the Diversified sector, which showed the second-highest compliance index value in the CGS score. According to Dissabandara (2012), the lower CGS score in the land sector is consistent with this research findings. One-way ANOVA results showed that there are differences across the sectors ($p < .05$). Furthermore, a post hoc comparison using Tukey's HSD test showed significant differences among various sectors exhibited in Panel B of Table 2.

4. Conclusion

The findings of this study indicate that the compliance level of corporate governance in 2016 was relatively higher than in South Asian economies such as Bangladesh but lower than that of India and Pakistan. According to CGI, the companies were classified into three main groups: 14 companies with Low CGI (with a CGI score of 0-40), 62 companies with Medium CGI (with a CGI score of 40-60), and 57 companies with Higher CGI (with a CGI score of 60-100). Moreover, this study revealed a disparity among the compliance levels between different sectors of CSE.

CGI and sub-indexes have lower values than 60, except for DI in Sri Lanka, compared to other countries, and considerable variations in the sectors are observed. Therefore, policymakers should consider taking necessary actions to improve corporate governance compliance in Sri Lanka, considering the lower level compliance sectors and sub-indexes, including shareholders, board of directors and CEO, and executive management. Especially concerning the areas such as the ease of doing business in Sri Lanka, the government can encourage foreign investors to deal with confidence, trust, and a range of investment options in Sri Lanka. Moreover, this study is beneficial to the investors for considering governance issues when investment decisions are made. Nevertheless, the present research has its limitations. Research data is based on annual company reports for one year only. Therefore, this study will consider a corporate governance index update after five years to compare with 2016.

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