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Corporate Governance Practices, Issues and Challenges in Sri Lanka

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Abstract

Aim of this paper is to examine the existing corporate governance practices, issues, and challenges in Sri Lanka. Over the past two decades corporate governance system and practices have gained great attention because of the corporate scandals taken place around the world. Asian financial crisis in 1997 showed that the region's need for legislative reform to strengthen corporate governance practices. Some corporate collapse in Sri Lanka made introduction of corporate governance system and new Company Act No. 7 of 2007. Further, Sri Lanka as an emerging market with the economic growth of 7.5% needs to protect investors who invest in Colombo Stock Exchange (CSE). This upward trajectory and need of investors' protection boasts CSE and corporate governance. Sri Lanka's corporate governance systems and practices have been largely influences by British system and post – government economic policies. The new Company Act prevents shareholders from collapse of companies. Concentrated ownership is the major issue in CSE and Investors Protection Index is also not in the satisfactory level. Some dominant families and political influences is the major challenge in CSE.

Key words: *Challenges, corporate governance, dispersion, issues, principles*
JEL Classification: *G30, G38*

1. Introduction

The term governance means that the institutional structures that are formal includes regulations and lows, informal includes norms, values and assumptions and which create constrains on the behavior of a related party (Gayle, Bhoendradatt and Whit (2003). Corporate governance is the system by which an organization makes and implements decision in pursuit of its objectives. It considers the process of decision making and the process by which decisions are implemented or not implemented (ISO FDIS 26,000). The governance body has authority to handle and utilize the organizational resources to achieve organization's goals and manage problem and affairs. "Corporate governance involves a network of relationship between corporate managers, directors, and the providers of equity capital" (7^{th} annual meeting of the international corporate governance network).

In a sole proprietorship, the proprietor has dual roles, as an owner and owner – manager directly involved in the profit maximization activities to his/her self interest. But, in other form of organizations the ownership and control activities are separated, managers' self – interest may lead to agency problem between managers and owners. Therefore, the investors (owners) expect assurance from corporate authority that their investment will be used as intended for the agreed corporate objectives. This assurance are the heart of what effective corporate governance is all about and corporate governance involves the relationship between related parties such as corporate to shareholders and society. The corporation enables to attract capital, perform efficiently in achieving the corporate objectives and meet legal obligations and general societal expectations with the combination of laws, regulations, listing rules, and voluntary principles. Therefore, the corporate governance's objectives are to accountability to shareholders and focusing on long term shareholder value.

2. Definitions of Corporate Governance

1. "Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment", (Shleifer and Vishny, 1997, page 737).

2. "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, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance", OECD April 1999. OECD's definition is consistent with the one presented by Cadbury.

3. "Corporate governance is about promoting corporate fairness, transparency and accountability" (Word bank, 1999).

4. "Some commentators take too narrow a view, and say it (corporate governance) is the fancy term for the way in which directors and auditors handle their responsibilities towards shareholders. Others use the expression as if it were synonymous with shareholder democracy. Corporate governance is a topic recently conceived, as yet ill-defined, and consequently blurred at the edges…corporate governance as a subject, as an objective, or as a regime to be followed for the good of shareholders, employees, customers, bankers and indeed for the reputation and standing of our nation and its economy" (Maw and Michael Craig-Cooper , 1994, page 1)

5. Corporate governance is a field in economics that investigates how to secure efficient management of corporations by the use of incentive mechanisms, such as contracts, organizational designs and legislation. This is often limited to the question of improving financial performance, for example, how the corporate owners can secure that the corporate managers will deliver a competitive rate of return, Encycogov's definition

3. Corporate Governance Practices in Sri Lanka

In early 1970s almost all enterprises in Sri Lanka were State Owned Enterprises (SOEs). The open economy policy was introduced in 1977 and privatization system was incorporated. This open economy policy leads to market oriented economy and impact on corporate governance mechanism. In this period state owned companies and central planning shifted to market oriented companies. As a result, the SOEs ownership has transferred to private ownership. Though, state ownership handed over to a few concentrated families, individuals and political leaders.

To attract new business and more investments Sri Lankan Government introduced free trade zones in 1970s; it leads to invite foreign investments. In the late 1990s, the Sri Lankan Government introduced up to LKR 20 million interest free loans to start business in the rural free trade zone. Resulted on these activities were the multinational companies in Sri Lanka and foreign ownership.

The corporate governance initiatives are commenced in Sri Lanka in 1990's with the introduction of the voluntary code of best practices on matters relating to the financial aspect of corporate governance.

The Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) and Securities and Exchange Commission (SEC) issued corporate governance code in the late 1990s and early 2000s. The rule on corporate governance which is the first corporate governance regulation was incorporated by as listing rules of CSE in 2008. The listing rules further amended by the

SEC in 2010 to address related party transactions and better prevent market shocks. The rules determine that the basis for determine the non-executives and independent directors in the company, set the minimum requirement to determine number of independence directors on both board and board committees, and disclose minimum requirements with respect to audit and remuneration committee.

Corporate governance standard were made mandatory for all listed companies for the financial year commencing on or after 1st April 2008. This code included the effectiveness of board, separation of the position of CEO and the chairmen, appointment of chairmen, non – executive directors, professional advisors, directors, training, directors responsibility for the presentation of financial statements, compliance reporting, internal control and committee structures for boards, including audit committee, and remuneration committees, and nomination committees.

The significant legislation enacted in Sri Lanka corporate governance was the Company Act No 7 of 2007 which replace the 25 years old Company Act No 17 of 1982. The Act introduces a solvency test and a company is required to satisfy the solvency test in several times to avoid bankruptcy problem. This test prevents shareholders from collapse of company. The new Company Act protects the interest of the shareholders, directors as well as managers. Sections 234, 235, 236 and 237 in new Act gives power to shareholders and directors to initiate derivative law suit actions. According to the section 92(1) the minority shareholders are given right to ask the company to buy back the shares if they think some actions or decisions of the company would damage their interests.

4. Corporate Governance Principles

Corporate governance in part, is the mechanism to minimize the loss of foregone value from separation of ownership and control. Morin & Jarrell (2001) argue that corporate governance acts as a framework to safeguard and control the relevant players such as managers, employees, customers, shareholders, executive directors, suppliers, and board of directors in the market. For this purpose Sri Lankan corporate governance system adopted the following corporate governance principles.

1. Ensuring the basis for an effective corporate governance framework

The Company Act No 7 of 2007 has made incorporating companies easier and more efficient, simplified the amalgamation of companies and, for the first time, permitted the existence of single shareholder companies. The Act also includes provisions relating to the duty of companies directors on the loss of capital, minority buy – outs, share repurchasing, share swaps, redemptions, and the further issuances of shares through public subscription.

2. The Rights of shareholders and Key ownership function.

The listing rules specifically address companies obligations to shareholders regarding their shares; the Listing Rules stated that companies must immediately inform the CSE about any development that affects materially the presents and potential rights or interest of the shareholders including changes in control. At the same time, do not make the connection between directors' responsibilities and the protection and promotion of shareholders rights.

3. The Equitable Treatment of Shareholders

Company Act No 7 of 2007 introduce an elements of "self help" into the Sri Lankan corporate governance system by granting shareholders and directors the rights to enforce provisions of the Act through private prosecution and private actions. Moreover, Company Act gives minority shareholders the power to force a company to purchase their shares when they object to the company engaging in a major transaction.

4. The Role of Shareholders in Corporate Governance

The Act provides significant implementation regard to the treatment of capital, directors duties and shareholders right.

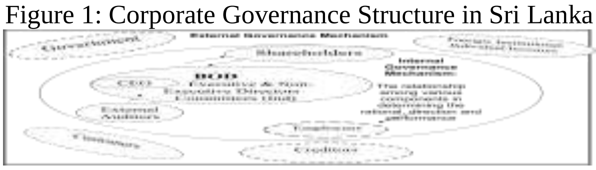
5. Corporate Governance Structure in Sri Lanka

The central to corporate governance thinking and practice are the shareholders, the board of directors and management. The code of corporate governance focuses on this set of players. Listing rules insisted the board of directors shall include at least two non executive directors in the board. Such number should be equivalent to one third of the total number of directors or whichever higher.

Audit committee is another player in corporate governance although they are not often presented as central to its purpose. This committee comprises of minimum of two independent non executive directors (in instances where a company has only two directors on its board) or exclusively by non executive directors a majority whom shall be independent whichever shall be higher.

External corporate governance mechanism comprises foreign, institutional, individual investors, government, customers and creditors and internal governance mechanism consist of board of directors (BOD), chief executive officers (CEO), and shareholders. Other relevant parties are the other stakeholders. The Figure 1 provides the corporate governance structure in Sri Lanka.

Figure 1: Corporate Governance Structure in Sri Lanka



Source: Securities & Exchange Commission of Sri Lanka

Corporate governance practices, principles and codes failed to provides solutions to the following issues:

1. Accountability – Corporate governance code requires only one third of the board of directors to be comprised of independence.
2. Transparency – Financial and annual reporting requirements are limited to basis information, with more robust details being excluded.
3. Shareholders rights and firm efficiency – Majority holders enjoy private benefits of control with the expenses of minority holders.
4. Equitable treatment - All shareholders do not have equitable treatment, one – share – one – vote rule break equitable treatment of all shareholders.

Sometimes close family members of majority shareholders become as company management and if the president or chairman is weak and cannot delegate power to management it will lead to bad practice of corporate governance codes.

6. Recent Trends in Corporate Governance in Capital Market in Sri Lanka

The number of listed companies has grown from 141 in 1977 to 290 in January 2014. This shows an increase of 105.7 per cent in this period. In 2002, government of Sri Lanka gave permission to foreigners to buy shares in CSE with the full value of issued capital either through approved country funds; regional funds and corporate bodies or as individuals subject to some exclusions and limitations. The new measures create the opportunities to get listed in CSE and successful in mobilizing equity capital (Samarakoon, 1999).

Corporate governance in Sri Lanka motivates concentrated ownership as well as large ownership of shares (Samarakoon, 1999; Gunathilake, De Zoysa and Chandrakumara, 2011). More than 86 per cent of shareholders hold less than 1000 shares. This concentrated ownership alleviate agency problem and create majority and minority holders problem (Kalainathan and Vijayarani, 2012). The following table provides details of majority and minority share dispersion in Sri Lanka in 2012 (data collected from 135 listed companies which are randomly selected from all sectors).

Table 1: Share Dispersion in Sri Lanka in 2012

Shareholdings	Number of Shareholders	% of shareholders	% of shareholding
1 – 10,000	531,589	94.00	7.26
10,001 – 100,000	28,118	4.97	7.66
Over 100,001	5,809	1.03	85.08
Total	**565,516**	**100.00**	**100.00**

Source: Calculated from annual reports of selected listed companies

The Table 1 shows that 94 per cent of the shareholders hold only 7.26 per cent of the equity shares in the CSE. This is another evidence for concentrated ownership in Sri Lankan stock market.

7. Challenges and Issues of Corporate Governance in Sri Lanka

Common issue of corporate governance is the concentrate ownership. Very small percentage of equity holders control large amount of shares. This ownership structure motivates private benefit of control and shares benefits of control in the capital market. First, large owners or their representatives usually serve as directors and officers, which put them in the position to influence management decisions directly. Second, there is evidence that formations of blocks are associated with abnormal stock price increases (Mikkelson and Ruback, 1985). Third, there is also evidence that the trades of large blocks are associated with abnormal stock price increases (Barclay & Holderness 1991, 1992). If large owners do not affect the cash flows that eventually accrue to minority shareholders, such stock price changes would be hard to explain. Gunathilake *et al.*, (2011) argue that Chief Executive Officers (CEOs) spending more money for the beauty of the office rather than the other essential needs.

Several corporate scandals taken place in Sri Lanka have caused great confusion in the stakeholders of the companies. The bankruptcy of Pramuka Bank, Vanic Incorporation, Lanka Marine Services Ltd, Sri Lanka Insurance Corporation and the Golden Key Credit Card Company (GKCC). It is apparent from the facts revealed so far that the collapse of GKCC is associated with both mismanagement and mis - appointment of funds by directors and managers of the company. These corporate scandals raise the obvious question as why such incidents take place and who is accountable for these incidents (Senaratne, 2009). The collapse of GKCC reveals that the failures of corporate governance system and existing corporate governance theories. These failures are not limited to the entities and stock market, but it could also affect entire economy and social system of the country.

Investors' protection in Sri Lanka ranked as 52 out of 187 countries. It is not provided confidence to investors to make more and more capital in Sri Lanka. The strength of investor protection index is 6.0 out of 10, it is little lower than OECD countries and higher than South Asian countries. Extend of disclosure index, Extend of Director Liability Index, and Ease of Shareholders Suits Index are also little bit higher than the South Asian countries. This world – wide comparison shows that there is a need to protect investors in Sri Lanka.

Many researchers (Gunathilake *et al.*, 2011; Weerakoon, 1995; Wickramasinghe, Hopper and Rathnasiri, 2004; Ratnayakara, 2006) argue that the political influence affect the implementation of rules and regulations in a proper way in Sri Lanka. Country economy shifted to market – oriented policies in 1977 as a result of this market – oriented policies and privatization public enterprise ownership has switched to private ownership, though ultimately this private ownership has ended up with a few concentrated family owners, individuals, institutions and political leaders. Still, there is no proper governance system to reduce this influence.

8. Conclusion

The paper examined the corporate governance practices, issues and challenges in Sri Lanka. The need for the corporate governance system was insisted after liberalization of economy in 1997. In 1990s with the introduction of voluntary code of best practices was introduced. First corporate governance regulation incorporated by CSE in 2008 and further amended in 2010. New Company Act No 7 of 2007 was introduced compulsory solvency test and this test prevent shareholders from company collapse.

Corporate governance structure is separated as internal and external governance mechanism. These both mechanisms reflect the entire stakeholders of the capital market and any failure of the system totally affect the society.

The Sri Lankan capital market controlled by the concentrated ownership structure and this concentrated owners are the institutions, directors and individuals (Kalainathan and Vijayarani, 2012). Therefore, the concentrated ownership and political influence are the major issues and challenges in the CSE. The study identify that the CSE need further improvement in the corporate governance system to protect investors in the capital market.

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