Corporate Governance Practices:
A Study of Sri Lanka

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Abstract — This paper precisely investigates the corporate governance practices by examining listed firms in Sri Lanka. Unusually, there is a lack of studies on corporate governance in developing countries. This research examines the relationship between corporate governance and firm performance. The study considers three ownership measures of corporate governance during the period 2008 to 2012. The study revealed there is a significant difference of performance among different ownership groups, including the firms’ majority ownership by directors, intuitions and outsiders.

Index Terms — Corporate Governance, Ownership Structure, Performance

I. INTRODUCTION

Many contemporary firms continuously seek for ways to improve on their activities. This explains why concepts such as business process improvement, re-engineering, total quality management, strategic management, corporate citizenship, corporate social responsibility (CSR) and business ethics have become buzzwords in the contemporary business world. It is difficult to define the concept of corporate governance in a universally acceptable way because definitions vary from country to country. Moreover, countries differ from each other in terms of culture, legal systems and historical developments (Ramon, 2001). This explains why there is a wide range of definitions of the concept of corporate governance. Corporate Governance as: “The mechanism that frames duties and powers of corporations to deliver benefits to investors and those directly impacted by the corporation’s activities.” Shleifer and Vishny (1997) define corporate governance in terms of the ways in which suppliers of finance to a firm assure themselves of a good return to their investment. The Australian Standard (2003) defines corporate governance as the process by which organizations are directed, controlled and held to account. This implies that corporate governance encompasses the authority, accountability, stewardship, leadership, direction and control exercised in the process of managing organizations. Since this definition recognizes the need for checks and balances in the process of managing organizations, it can be considered to be more comprehensive (Gregory, 2000).

A good corporate governance regime helps to assure that corporations use their investment efficiently. Good corporate governance helps to ensure that corporations take into account interest of the wide range of constituencies as well as the communities within which they operate and that their boards are accountable to the company and the shareholders. The corporate governance debate was activated in emerging economics following the collapse of the East Asian financial market with the sudden exit of foreign capital investment in 1997. The East Asian financial crises (which was described by World Bank as East Asian miracle) was initialized when Japan declared its intention to raise interest rates to defend the yen. The crises emerged following the Thai Government’s declaration of a devaluation of their currency, to correct their balance of payment problem on 02nd July 1997 (Richardason, 1998). The crisis began with mild panic or loss of confidence by domestic and international investors that had no real foundation and was made serious only by the International Monetary Fund (IMF) pressure to increase interest rates and to close down banks (Radelet and Sachs, 1998).

There is no serious corporate outrage in Sri Lanka to undermine investors’ confidence and the wave of Asian financial crises didn’t affect the Sri Lanka economy including the capital market and money market. This was due to the absence of foreign debt in Sri Lanka corporate sector. However, corporate governance issues have been still prevalent in Sri Lanka for a few reasons. For example the existing good corporate governance best practices are not comprehensive and adequate. There is no legislative guideline for controlling share ownership, no legislative guideline for the director’s duties. Therefore directors are sometimes found to be involved in malpractice, which is exemplified by collapse of state and public owned enterprises (Bhaskar ad Khan, 1995) It can be inferred from these events that the operation of good corporate governance is essential to the financial health of Sri Lankan firms.

Sri Lanka has an emerging economy it is still considered less developed and has received a lot of attention in the financial literature during recent years. Specially, after the conclusion of the domestic ethnic wars from 1970 to 2009, Sri Lanka enters the post war recovery phase; reform of the financial system has become essential in accelerating economic growth. Sri Lanka has recently started adopting several economic reforms, namely, infrastructure development,
processes of deregulation, and fostering international integration. As a result, long term investment has increased significantly.

Although there are a few studies on corporate financial reporting in the context of Sri Lanka such as Velnampy and Pratheepkanth (2012), Kajananthan (2012), and Velnampy (2013); to date there very limited studies on corporate governance in Sri Lanka apart from few studies on leadership style, board committee, board size, board meeting, and board composition in the Sri Lankan.

However, none of these studies covered any aspects of corporate governance such as ownership structure, capital structure and compensation. Rashid and Lodh (2008) in their study attempt to extend the earlier studies by examining whether ownership structure influence corporate social disclosures practices, but that study does not cover the wider aspect of corporate governance in developing environment. There are two studies (Farooque et al., 2007) so far seen on ownership structure and firm performance in the contact of less developed market. This study has some fundamental differences from earlier studies of corporate governance in Sri Lanka. This study provides an insight as well as empirically examines if specific corporate governance arrangements influence the performance in Sri Lanka. This study on corporate governance is conducted in less developed and emerging economics context by considering Sri Lanka as a case study. This study seeks to improve the corporate governance practices in Sri Lanka which may help enhance the performance.

A. Statement of the Problem

Construction on the objectives of the study that were described earlier in section 1, this study proposes the following research question to correspond with the scope:

- Does the ownership structure influence the firm performance?

II. RELEVANT LITERATURE AND HYPOTHESIS DEVELOPMENT

Berle and Means (1932) set forth that ownership dispersion implies management is distanced from ownership, which, as Jensen and Meckling (1976) emphasize, may contribute to agency problems between managers and shareholders or shareholders and debtors. On the other hand, Shleifer and Vishny (1986) and Morck, Shleifer and Vishny (1988) detect the phenomenon of ownership concentration. La Porta et al. (1999) and Claessens et al. (2000) usher in the conception of ultimate controller; they define firm ownership as voting rights, unearthing that many controlling shareholders of listed firms predominate firms by means of pyramid structure and cross holding, which could result in central agency problem. Kao, Chiou and Chen (2004) reveal that firms in financial distress are closely related to high ratio of the shares pledged by directors, causing concern about the agency problem resulting from the pledge of corporation shares. Chiou, Hsung and Kao (2002) indicate that, directors and supervisors could fund by the collateralized shares and further purchase more firm stocks to manipulate stock price or enhance their power. Directors’ and supervisors’ financial stress, because of the collateralized shares, is closely related to share price. Share price slumping, the value of the collateralized shares depreciates and even drops below the standard of the required margin; correspondingly, collateralizing shareholders will be requested to collateralize more shares, while debtors fail to afford more shares as collaterals, financial institutions as creditors will close the position of collateralized shares. As a result, collateralizing shareholders, making use of their position, may make a prey of small shareholders or embezzle company funds.

Considering the influence of shareholder activism in governance reforms is important to obtain insight into governance practices (Daily et al., 2003). To date, institutional investors’ participation has emerged as important force in corporate monitoring to serve as mechanisms to protect minority shareholder’s interest. The significant increase in the institutional investors’ shareholdings has led to the formation of a large and powerful constituency to play a significant role in corporate governance. Example, in US, the California Public Employees’ Retirement System (CalPERS) has been active in seeking greater director independence and in firms in which they invest their fund, CalPERS request for the firms to have majority independent directors to sit on the board and even al., 2003). In the UK, institutional investors own between 65 to 75 percent of the United Kingdom stock market which suggest a prominent role that institutional shareholders can play as an agent to the governance systems (Mallin, 2003). In fact, Hermes Investment Management, owned by and is principal fund manager for the British Telecom (BT) Pension schemes manage over 75 billion euro representing equity investments in over 3000 companies worldwide and is the largest institutional investors in the UK (Lee, 2003).

To mitigate the problems associated with conflict between controlling owners and minority shareholders in Asia firms, the involvement of institutional investors’ equity participation may improve corporate governance practices (Claessens and Fan, 2002). Concentrated shareholdings by institutional provide an incentive for diligent monitoring as they have the resources, expertise and stronger incentives to actively monitor the actions of management and prevent managers’ opportunistic behaviour (Wan Hussin and Ibrahim, 2003). Given they own substantial shareholdings that make it difficult to sell shares immediately at prevailing price, the institutional investors have greater incentives to closely monitor companies with high free cash flow (Chung et al., 2005). Extending prior research that look into the role of internal governance mechanisms and earnings management, Mitra and Cready (2005) provide evidence that active monitoring from the institutional investors also help to prevent managerial opportunistic reporting behaviour and improve the quality of
governance in the financial reporting process. They find that institutional shareholders intervene and mitigate the self-serving behaviour of corporate managers in financial reporting based on a sample of 136 companies belong to the S&P 500 group and 237 belong to non-S&P 500 category for eight years period (1991-1998).

However, it is depend to the relationship between the institutional investors and the controlling owners as the rent seeking and relationship based transaction may avoid the institutional to monitor the controlling owners and not force them to disclose all information to the public as their value will also be affected (Claessens and Fan, 2002). Chung et al. (2005) find evidence that institutional shareholder moderate the discretionary accrual and surplus free cash flow relationship when the surplus free cash flow is high. The presence of institutional investors with substantial shareholdings restrain managers from engaging in income increasing discretionary accruals when companies have high free cash flow, however, when there is no free cash flow agency problems, the institutional investors do not effectively constrain the management’s use of income increasing discretionary accrual.

In Malaysia, total institutional shareholdings stood at about 13 percent of the total market capitalization of Bursa Malaysia (for year 2003) that account for higher percentage of institutional shareholdings compared to other countries in the same region (Abdul Wahab et al., 2003). In fact the Employee Provident Fund (EPF) accounts for 86 percent of the total RM173 billion of provident and pension fund (Thillainathan, 1999). Although the institutional shareholdings are growing in the Malaysian capital market, empirical evidence on the effect of institutional shareholding and accounting issues are very limited. Abdullah (1999) is first to examine the relationship between institutional shareholdings evidence that the presence of institutional investors lead to lower earnings quality as predicted in their hypothesis. He argues that Malaysian institutional investors prefer short-term investment rather than long-term achievement that that make their decision to dispose their substantial shareholdings inevitably depress the market share price dramatically that support ‘myopic investor’ hypothesis. However finding by Abdullah (1999) may be arguable for recent capital market development that shows greater institutional investors’ participation as corporate monitoring. Institutional investors in Malaysia nowadays have become a very large and powerful constitution that plays a very significant role in corporate governance to protect minority shareholder’s interest. Recent study by Abdul Wahab et al. (2004) provide evidence of a negative and significant mono directional causality that run from institutional ownership to performance which suggest that institutional shareholding is a determinant of poor performance but poor performance.

While having independent directors appear to be critical to the effectiveness of the boards’ monitoring function, the extent of management ownership held by management may affect control over the board. Jensen and Meckling (1976) theorize as management ownership increases, their interests will be more closely aligned with owners and the need for intense monitoring by the board should decrease. Bathala and Rao (1995) argue that the role of outside board members is less critical for firms with higher proportion of inside ownership. They find an inverse relationship between the proportion of outside board members and inside ownership of equity of 261 US listed firms which suggest that higher proportions of insider ownership held by inside board members help to closely align the managerial and shareholder interests, thus, reduce the need for intense monitoring from external board members.

While Bathala and Rao (1995) focus on inside members’ ownership, Beasley (1996) studies the effect of outside directors’ ownership and financial statement fraud. He provides evidence of significant negative relationship between outside directors’ ownership and the likelihood of financial statement fraud. His findings suggest that higher level of ownership held by outside directors do help reduce the likelihood of financial statement fraud. Additionally, Peasnell et al. (2005) include managerial share ownership as the intervening variable and posit that the constraining association between earnings management and the proportion of outside directors will be more prominent when the level of managerial share ownership is low. Prior researches by Peasnell et al. (1998 and 2003) find that managerial share ownership is significantly associated with the proportion of outside members. The demand for non-executive directors is lower in companies where the level of managerial ownership is high as shareholders let the management run the companies (Peasnell et al., 1998). Although Peasnell et al. (2005) find only slightly significant association on the three-way interaction of managerial ownership, outside director and income increasing abnormal accrual, this finding shed a light for future research on the interaction of managerial ownership and the proportion of outside directors in constraining earnings management behaviour. Recognizing the importance of the tightness of ownership of Malaysian companies that influence the governance structure in Malaysia, Abdullah (2006a) investigate the influence of management and non-executives interest on the firm financial distressed of 86-matched sample of distressed and non-distressed companies for a period of 1999-2001. Although fail to find evidence on the relationship between board independence and CEO duality on firm value, he found significant effect of management interests on firm value at the lower level and higher level of ownership. Additionally, paper by Abdullah (2006b) that extends Abdullah (2004) research on performance by investigating the extent to which firm’s performance, internal governance of board of directors and ownership structure determine directors’ remuneration of Malaysian public listed companies.
Based on the extent literature, there three hypotheses proposed to be tested.

Hypothesis 1: There is a significant association between the percentage of shares owned by the directors and firm performance

Hypothesis 2: There is a significant association between the percentage of shares owned by the institutions and firm performance

Hypothesis 3: There is a significant association between the percentage of shares owned by the outsiders and firm performance

III. RESEARCH APPROACH AND METHODS

Research methodology is a way to systematically solve research problems. It is a science of learning how research is to be carried out (Rajasekar, Philominathan, & Chinnathambi, 2000).

A. Sampling Design

The population of interest in this study is two hundred and eighty eight (288) listed firms in Colombo Stock exchange (CSE). In order to select the sample, purposeful sampling method used, which implies intentionally selecting firms to learn to understand the research objectives and awareness is to purposefully select respondents who will best answer the research questions of this research. After eliminating outliers, the sample size is sixty (60) Sri Lankan listed firms as the sample.

B. Variable Measurement

Ownership variable is the representation of the shareholders in a corporation. The form of panmidal or cross shareholding structure is not very common in Sri Lanka. Therefore there is no guideline regarding the ultimate controlling ownership in Sri Lankan companies Act 2007. Farrar (2005) argues that the shareholders in a modern company can classified into three categories. There are the (a) significant shareholders, (b) intuitional shareholders and (c) individual shareholders. Listed companies in:

<table>
<thead>
<tr>
<th>Ownership Category</th>
<th>Definition</th>
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<tr>
<td>Directors Ownership</td>
<td>Percentage of shares owned by directors</td>
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<tr>
<td>Institutional Ownership</td>
<td>Percentage of shares owned by institutions</td>
</tr>
<tr>
<td>Outside Ownership</td>
<td>Percentage of shares owned by public other than the directors and institutions</td>
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C. Firm Performance

To explore the relationship between corporate governance and firm performance, different measures of corporate performance, notably the net profit ratio (NP), return on assets (ROA), return on equity (ROE), Operating rate of return (ORR), earnings per share (EPS), price earnings ratio (PE) and Tobin Q (TQ) has been used in existing literature. Firm performance in this study will be measured in terms of the financial and operational scope. Thus the researcher takes measures widely used by firms, namely ROA and ROE will be employed as measures representing accounting performance measures while Tobin’s Q will be used to measure the market performance of firms. ROA, ROE, TQ and EPS will be measured in terms of five (05) years average during the period from 2008 to 2012.

IV. RESULTS AND DISCUSSION

The Univariate analysis was employed to test if there are significant differences of firm performance among various ownership groups, including the firm’s popular ownership by directors, intuitions and outsiders. Table 01 represents significant level of the comparison of the mean value of firm performance under difference performance measures say ROA, ROE and Tobin’s Q. It is exposed that firms which popular ownership by directors are over performing compared to all firms and other ownership concentration under all their performing compared to all firms and other ownership concentration under all the performance measures.

<table>
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<tr>
<th>Ownership Types</th>
<th>Performance Measures</th>
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<tr>
<td></td>
<td>ROA</td>
</tr>
<tr>
<td>All Firms</td>
<td>0.00440</td>
</tr>
<tr>
<td></td>
<td>(0.082)</td>
</tr>
<tr>
<td>Directors</td>
<td>0.078***</td>
</tr>
<tr>
<td></td>
<td>(0.073)</td>
</tr>
<tr>
<td>Institutional Owned</td>
<td>0.031***</td>
</tr>
<tr>
<td></td>
<td>(0.015)</td>
</tr>
<tr>
<td>Outside Ownership</td>
<td>0.028***</td>
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<td>(0.060)</td>
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The correlation matrix of the explanatory variables, it is discovered that there are no heavy correlations among them as the correlation coefficients are very small. Based on the analysis, the hypothesis 1 is accepted.

The regression coefficients suggest that there is a positive impact between the percentages of shares owned by directors
and firm performance. The regression coefficients suggest that there is no significant impact between the percentage of shares owned by institutions and firm performance proxies. Based on this analysis the Hypothesis 2 is rejected.

The regression coefficients suggest that there is a significant negative relationship between the percentage of shares owned by outsiders and firm performance. Based on this analysis the hypothesis is rejected.

REFERENCES


