Corporate Governance Practices and Firm Performance of Listed Companies in Sri Lanka

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Declaration

I, Kumudini Heenetigala, declare that the DBA thesis entitled *Corporate Governance Practices and Firm Performance of Listed Companies in Sri Lanka* is no more than 65,000 words in length, exclusive of tables, figures, appendices, references and footnotes. This thesis contains no material that has been accepted for the award of any other degree of diploma in any university or institution. To the best of my knowledge, this thesis contains no material previously published or written by another person, except where due reference has been given.

KUMUDINI HEENETIGALA **DATE**

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Abstract

Introduction:

Corporate governance is considered to have significant implications for the growth prospects of an economy. Good corporate governance practices are regarded as important in reducing risk for investors, attracting investment capital and improving the performance of companies. However, the way in which corporate governance is organized differs between countries, depending on their economic, political and social contexts.

Purpose:

The purpose of this study was to examine the relationship between corporate governance practices and firm performance in Sri Lanka, as a result of the adoption of code of best practice on corporate governance in 2003 and the extent of changes to corporate governance practices four years after (2007). During this period), the firms that operated in Sri Lanka were affected by political and economic instability. However, the stock market performed well.

Critical Literature Review and the Contribution:

The theoretical basis for this study was agency theory, which focuses on the separation of ownership and control. Literature in relation to corporate governance practices and firm performance reported mixed results. The conceptual framework underpinning this study described how the board structure and corporate reporting practices of firms in Sri Lanka impacted on firm performance. In this framework corporate governance variables were separate leadership, board composition, board committees and corporate social responsibility (CSR) reporting. Separate leadership refers to the separation of the position of chairman and CEO; board composition refers to a majority of non-executive directors on the board; board committees refers to the presence of audit, remuneration and nomination committees; and corporate social responsibility reporting refers to reporting of CSR activities. Accountability to shareholders and other stakeholders was assessed through corporate reporting practices in relation to corporate social responsibility reporting. The research explored

the relationship of these variables to firm performance. Firm performance was assessed by Return on equity, Return on assets and Tobin's Q.

This is the first study conducted in Sri Lanka on corporate governance and firm performance during periods of high volatility in the environment due to adverse economic and political conditions. As a result, this study makes a significant contribution to the body of knowledge on corporate governance in developing countries and illustrates how corporate governance impacts on firm performance in unstable environments such as that experienced in Sri Lanka.

Methodology:

This study is a comparative analysis to gauge the changes to corporate governance practices from 2003 to 2007. A sample of 37 companies was selected from the top 50 listed companies in *The Lanka Monthly Digest 50* (LMD) for the years 2003 and 2007. The selection was determined by the availability of data for both years. Data were obtained from annual reports and *The Lanka Monthly Digest 50*. The data were analysed with SPSS to obtain quantitative measures of descriptive statistics, Spearman's correlation and analysis of variance.

Results, Discussion and Implications:

Descriptive statistics from the study showed a significant increase in corporate governance practices between 2003 and 2007 for board composition, board committees and corporate social responsibility reporting. As a result of the increased governance practices in 2007, this study provides evidence in support of a positive relationship for separate leadership, board composition, board committees and firm performance based on return on equity. Both board composition and board committees also had a significant relationship with performance measured by Tobin's Q in 2007. However, corporate social responsibility reporting practices by the firms in Sri Lanka did not report any relationship to firm performance in 2007.

In this study, the positive relationship between corporate governance structures, separate leadership, board composition, board committees and firm performance indicate that firms have implemented corporate governance strategies, which have resulted in higher profitability and share price performance.

Corporate social responsibility reporting practices in this study did not find evidence of a relationship to performance during the period under study. This may have been due to the fact that CSR was considered a philanthropic act by the markets and not related to business, especially due to the rebuilding activities after the 2004 tsunami. This study supports the agency theory propositions that good corporate governance practices enhance boards' accountability to shareholders and improve a company's performance. The lack of relationship between CSR reporting and performance suggests that stakeholder theory is not supported.

Conclusion:

The conclusions drawn from this study were that even in adverse economic and political conditions, good corporate governance practices were important to the performance of firms operating in Sri Lanka. However, for corporate governance practices to have full impact on firm performance in Sri Lanka, boards should consider CSR strategies that are in the interest of all stakeholders and relevant to the business.

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Acronyms

ANOVA	Analysis of Variance
ASX	Australian Securities Exchange
Bsize	Board Size
CEO	Chief Executive Officer
CGI	Corporate Governance Index
COMM	Board Committees
COMP	Board Composition
CSBA	Colombo Share Brokers Association
CSE	Colombo Stock Exchange
CSR	Corporate Social Responsibility
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GFC	Global Finance Crisis
ICASL	Institute of Chartered Accountants of Sri Lanka
ICGN	International Corporate Governance Network
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
LDS	Leadership Structure
LMD50	Lanka Monthly Digest 50
LTTE	Liberation Tigers of Tamil Elam
MCAP	Market Capitalisation
NONEX	No of Non-executive Directors
NPV	Net Present Values
OECD	Organization for Economic Co-operation and Development
REP	Corporate Reporting
ROA	Return on assets
ROE	Return on Equity
SBE	Specified Business Enterprises
SEC	Securities and Exchange Commission
SLAASMB	Sri Lanka Accounting and Auditing Standards Monitoring Board
SLAS	Sri Lanka Accounting Standards
SLAuS	Sri Lanka Auditing Standards
SRB	Socially Responsible Business
TA	Total Assets
TQ	Tobin's Q
WBCSD	World Business Council for Sustainable Development

Chapter 1
Introduction

1.1 Background

Corporate governance has become a popular discussion topic in developed and developing countries. The widely held view that corporate governance determines firm performance and protects the interests of shareholders has led to increasing global attention (1997). However, the way in which corporate governance is organized differs between countries, depending on the economic, political and social contexts. For example, firms in developed countries have dispersed shareholders and operate within stable political and financial systems, well developed regulatory frameworks and effective corporate governance practices. However, firms that operate in developing countries such as Sri Lanka may be affected by political instability resulting in severe economic dislocation and sharp escalation in defence expenditure, which result in a widening fiscal deficit.

In Sri Lanka, apart from weak regulatory and institutional frameworks, increasing oil prices, overvalued exchange rates and rising inflation have been growing macroeconomic problems that were further worsened by the December 2004 Tsunami and global finance crisis (GFC), which in turn affected the performance of firms. Remarkably, despite all these setbacks, the stocks in Sri Lanka have generally continued to perform well, and the value of firms increased. The important issue in this case is to understand why, in such a volatile environment as Sri Lanka, the stock markets have managed to perform well. Referring to this situation, Bloomberg (Feb 27th, 2007) pointed out that as the capital market in Sri Lanka does not reflect its political situation, its corporate governance requires investigation to provide an understanding of why its corporate sector has remained resilient to adversity in the business environment.

To investigate the reasons for the effectiveness of corporate governance in the context of Sri Lanka, this study will firstly examine literature on the relationship between board structure, corporate reporting and firm performance. It will then examine the accountability to shareholders and other stakeholders through corporate reporting mechanisms. In order to provide a basis for this investigation the structure of this chapter is organized as follows: Section 1.2 provides an overview of the context of the study; Section 1.3 explains the relationship of corporate governance practices with firm performance; Section 1.4 presents the aims of the study; Section 1.5 presents the conceptual framework to conduct the study; Section 1.6 presents the methodology to be used; Section 1.7 discusses the limitation of existing literature; Section 1.8 explains the contribution to knowledge and significance of the study; and Section 1.9 describes the structure of the thesis.

1.2 Context of the Study

As the development of the capital markets in Sri Lanka is a result of the liberalization of the economy in 1977, among other things, the country has experienced good performance and increased investor confidence in listed companies. For example, *Bloomberg Newswire* named the Colombo Stock Exchange (CSE) as the best performing market in Asia and the fourth best performing in the world. According to *India Today* (2006) Sri Lanka is among the "hottest" stock markets in the world. Bloomberg (27 Feb 2007), points out that despite the ethnic war and political situation in Sri Lanka, stocks in the index sold for 15 times the earnings of the past year, which was 11 times above their five year average. In contrast, the companies listed in the Morgan Stanley Capital International Asia Pacific (excluding Japan) index sold for 17 times below their five-year average in the same year. At the end of the ethnic war in May 2009, the Sri Lankan stock market was reported as one the best performing stock markets in the world (Daily News 2009).

In order to attract foreign direct investment, organizations such as the World Bank and International Monetary Fund (IMF) are promoting better governance for their member countries and wider networks. As a result, corporate governance initiatives in Sri Lanka commenced in 1997 with the introduction of a voluntary code of best practice on matters relating to the financial aspects of corporate governance.

Thereafter, voluntary codes of best practices on corporate governance were issued in 2003 (ICASL 2003), and in 2007 corporate governance standards were made mandatory for all listed companies for the financial year commencing on 1st April 2008.

1.3 Corporate Governance Practices and Firm Performance: The Issues

In order to understand the governance practices referred to in this study, a discussion on the important aspects of corporate governance practices and firm performance is required.

1.3.1 Corporate Governance Practices

Cadbury (1992) defined corporate governance as “the system by which companies are directed and controlled”. It is concerned with the duties and responsibilities of a company’s board of directors to successfully lead the company, and their relationship with its shareholders and other stakeholder groups (Pass 2004). It is also defined as a “process through which shareholders induce management to act in their interests, providing a degree of investor confidence that is necessary for the capital markets to function effectively” (Rezaee 2009).

In general, corporate governance is considered as having significant implications for the growth prospects of an economy, because proper corporate governance practices reduce risk for investors, attract investment capital and improve performance of companies (Spanos 2005). In Sri Lanka, effective corporate governance is considered as ensuring corporate accountability, enhancing the reliability and quality of public financial information, therefore enhancing the integrity and efficiency of capital markets, which in turn will improve investor confidence (Rezaee 2009).

There is no globally accepted set of corporate governance principles that can be applied to board structures as they depend on business practices and the legal, political and economic environment. However, the Cadbury Committee (1992) considered board structure as an important corporate governance mechanism, which would result in improved performance. They addressed board structures, separation of the roles of Chief Executive Officer (CEO) and Chairman, non-executive directors representation and board committees. These were also addressed in the code of best practice on corporate governance issued in Sri Lanka. Due to their importance in affecting firm performance, board structures will be considered in this study.

Board Leadership Structure

The first issue that the Sri Lankan code required for effective corporate governance was the separation of the top two positions of the board (CEO and Chairman). Abdullah (2004) states that the reason for separation is that when both the monitoring and the implementation roles are vested in a single person (combined leadership) the monitoring role will be severely impaired. Furthermore, companies that have combined leadership may have an individual who has too much power and is able to make decisions that do not maximize shareholders wealth (Laing & Weir 1999). Alternatively, it could also be argued that when one person is in charge of both tasks, favourable decisions are reached faster provided that person is well aware of the decisions needed to improve the performance of the firm (Abdullah 2004).

Evidence in relation to company performance and board leadership structure is mixed. Rechner and Dalton (1991) found that firms with separate leadership structures outperformed joint structures when measured on return on equity, return on investment and profit margins, whereas Dalton et al. (1998) found no evidence of a relationship between leadership structure and financial performance. According to Abdullah (2004), board independence and combined leadership either singly or jointly are not related to performance.

Board Composition

In the code of best practice on corporate governance in Sri Lanka, board composition is also an important component of the board structure. The assumption is that an effective board comprised of a greater proportion of outside directors (Zahra & Pearce 1989), is significant to firm performance. According to agency theory, these outside non-executive directors are able to provide superior performance as a result of their independence from firm management (Dalton et al. 1998). Alternatively, stewardship theory argues that managers are good stewards of the corporation and work to attain high levels of corporate profits and shareholder returns (Donaldson & Davis 1994).

Empirical evidence regarding the relationship between firm performance and board composition is mixed. Baysinger and Butler (1985), found that firms with higher numbers of outside directors on the board had a greater return on equity than the board with inside directors. Ezzamel and Watson (1993) also found that outside directors were positively associated with profitability among a sample of UK firms.

Contrary to the above and consistent with the stewardship theory, Kesner (1987) found a positive and significant relationship between the proportion of inside directors and returns to investors. However in contrast, there is also a large body of research, which has found no relationship between composition and firm performance (Abdullah 2004; Chaganti, Mahajan & Sharma 1985; Daily & Dalton 1992, 1993a; Kesner, Victor & Lamont 1986).

Board Committees

In order to perform better and alleviate agency conflict between shareholders and senior management, Sri Lankan companies have introduced board committees (as recommended in the Sri Lankan code of best practice), because oversight functions of the board are primarily carried out by the board committees (Rezaee 2009). Cadbury (1992) also highlighted the importance of board committees and proposed to set up sub-committees of the board to focus on specific aspects of governance that are considered problematic. These include financial reporting, remuneration of board and senior management, and appointments to the board (Spira & Bender 2004). However, studies which report the relationship between board committees and firm performance is limited.

Corporate Reporting

Firm performance in Sri Lanka is also affected by corporate reporting practices of the firm. Better management practices of firms is translated into better performance leading to higher share prices and enhanced returns as a result of timely and accurate disclosure of information which is provided through corporate reporting practices of firms (Mobius 2002). Corporate reporting is not only financial reporting but information beyond that which is required by the regulation (Corporate Law and Accounting Standards), provided through the annual reports to their shareholders and other stakeholders (Eccles 2004). Corporate social accountability and reporting is information over and above that which is mandatory, and is seen as a key driver for engaging the wider community as an important stakeholder in business activities (Zairi & Peters 2002). In support of this view, other stakeholder theorists consider that a firm's responsibility is not only to its shareholders, but to all stakeholders whose contribution is necessary for its success (Balabanis, Philips & Lyall 1998).

Even though corporate social responsibility (CSR) is a fairly a new concept, many scholars have examined the relationship between CSR and firm performance. Buhr and Grafstrom (2007) state CSR is referred to in the *Financial Times* as a business policy that would create new market opportunities, competitive advantage and customer satisfaction, which supports the argument that CSR is compatible with profit maximization. A number of studies have produced results consistent with the notion that corporate social responsibility activities impact on financial markets (Anderson & Frankle 1980; Shane & Spicer 1983; Spicer 1978). There are others who state that adopting corporate social responsibility can improve the value of firms in developing markets to a higher degree than developed markets. In many developing markets there is social, economic and cultural chaos. Therefore, by promoting social justice, these problems can be reduced, thereby by benefiting the society as a whole and the value of firms in particular (Banks 2004; Crowther & Lez-Rayman-Bacchus 2004).

1.3.2 Firm Performance

Firm performance is affected by corporate governance practices of firms in Sri Lanka, because their success or failure is dependent on the extent to which they are managed efficiently. Good corporate governance practices enhance firm performance through better management and prudent allocation of firms' resources. Earnings resulting from increased performance, contributes significantly to share prices. Therefore good corporate governance practices can increase the demand for shares as well as increase the price of shares of a company (Mobius 2002).

A wide variety of definitions of firm performance have been proposed in the literature (Barney 2002). For example, both accounting and market definitions have been used to study relationships between corporate governance, corporate social responsibility and firm performance (Orlitzky, Schmidt & Rynes 2003). Conversely, stakeholder views regard firm performance as being the total wealth generated by the firm before distribution to the various stakeholder rather than the accounting profit allocated to the shareholders (Riahi-Belkaoui 2003).

1.4 Aim of the Study

The introduction of corporate governance practices in Sri Lanka aimed to provide a mechanism to improve investor confidence and trust in management and promote economic development of the country. However, efficiency of the corporate governance structures and practices on corporations operating in the highly volatile environment of Sri Lanka has not been empirically investigated. Therefore, in order to understand the governance practices that contribute to enhance the value of listed companies in Sri Lanka, the study aimed to:

> Explore the efficacy of corporate governance practices, which affect firm performance resulting in accountability to shareholder and other stakeholders through appropriate corporate reporting practices, which enhances the value of the firms of listed companies in Sri Lanka.

This research determined relationships between the corporate governance practices of board structures (consisting of leadership, composition and committees) and corporate reporting practices of CSR reporting and firm performance of listed companies in Sri Lanka.

Therefore this study examines the relationship between corporate governance practices and firm performance in Sri Lanka, as a result of the adoption of code of best practice on corporate governance in 2003 and the extent of changes to corporate governance practices four years after (2007).The specific objectives of the study are to:

1. Examine the development of corporate governance practices in the context of the Sri Lankan business environment;
2. Investigate the extent to which the companies have adopted corporate governance practices;
3. To determine through a comparative analysis the changes in corporate governance practices between its introduction in 2003 and the time of the study in 2007;
4. Analyse the board structures of the listed companies;
5. Examine corporate reporting practices and the extent of corporate social reporting disclosures among the listed companies;
6. Determine the relationships between corporate governance practices (such as board leadership structure, composition, and committees), and CSR reporting on firm performance; and
7. Recommend a corporate governance model with an emphasis on corporate governance practices, including board structure and reporting that results in accountability to all stakeholders.

1.5 Conceptual Framework

Based on a review of the relevant literature, this research investigates corporate governance practices and firm performance in a particular business environment.

This section introduces a theoretical framework suited to the context of Sri Lanka, based on agency, stewardship and stakeholder theories to address the relationships between corporate governance practices and firm performance in Sri Lanka. In this framework corporate governance variables (leadership structure, composition and committees) appear as monitoring mechanisms of the board, whereas accountability to shareholders and other stakeholders is assessed through corporate reporting practices of CSR reporting through firm performance.

The four variables related to corporate governance practices, which are very significant in the Sri Lankan context in affecting firm performance in this study include: board leadership structure, board composition, board committees and corporate reporting practices. The firm performance is measured in terms of accounting and market-based measures.

The three financial firm performance measures in the study, namely return on equity (ROE), return on assets (ROA) and Tobin’s Q, are considered as proxies for accounting returns and market returns. ROE is an accounting measure used to assess rates of return on shareholder equity and has been used in previous studies to measure firm performance (Epps & Cereola 2008; Leng 2004), whereas ROA which is also an accounting measure, is used to assess the efficiency of assets employed to measure firm performance in prior studies (Bonn, Yoshikawa & Phan 2004; Haniffa & Hudaib 2006). Tobin’s Q is a measure of market performance, which compares the value of a company as given by financial markets with the value of the company’s assets (Tobin 1969).

1.6 Methodology

To investigate the relationships between corporate governance practices and firm performance in Sri Lanka, this study employed methodologies adopted in prior research in this area. Most studies which investigate these relationships have used a positivist research paradigm of a deduction method and quantitative techniques to analyse the data that is collected from secondary sources.

In order to examine the extent to which companies in Sri Lanka had adopted code of best practice on corporate governance in 2003 and the changes to corporate governance practices four years after (2007), a comparative analysis was conducted. Analysis was conducted using SPSS software package. Descriptive statistics were used to calculate the mean difference for the years 2003 and 2007. T-tests were conducted to determine the significance of the differences between the means of 2003 and 2007. Correlation analysis was conducted to find out if there is an association between governance variables and firm performance. Finally, analysis of variance was conducted for the two year to find if there are significant interactions between corporate governance practices and firm performance.

Data were collected from secondary sources including annual reports, journals Lanka Monthly Digest 50 (LMD50) and the Colombo Stock Exchange publications and website. The sample of companies and firm performance data were selected from the top 50 listed companies in the LMD50 journal for 2003 and 2007 for comparative analysis. Data concerning board structure and corporate reporting was collected from annual reports of the selected companies.

1.7 Limitations of the Existing Literature

Even though there is a growing body of literature on corporate governance practices and company performance, there is a diversity of results due to the different theoretical perspectives applied, selection of methodologies, measurement of performance, conflicting views on board involvement in decision making and the contextual nature of individual firms (Kakabadse, Kakabadse & Kouzmin 2001). Kakabadse et al. (2001) also found that political opportunity, structure, stakeholder interest, social infrastructure and mobilization have an influence on corporations and corporate stakeholders, demanding attention for good corporate governance practices. In addition most research in the area of corporate governance has been conducted in the developed economies.

However, there is very limited research on corporate governance practices and the performance of companies in developing countries such as Sri Lanka, which operate in difficult environments (continuous internal wars, insurgencies, political instabilities, Asian crisis, Tsunami devastation, increased oil prices and global financial crisis), yet manage to perform strongly in the corporate sector.

Although, literature on CSR and its impact on firm performance are focused on developed economies, it is limited in the context of emerging markets. Furthermore, institutional legal frameworks in emerging economies are not well developed compared to developed countries, which limits the benefits of their corporate governance efforts. These emerging economies show significant differences in terms of economic growth, business environments, income levels and management practices.

Given the difficult economic and political environment in which businesses in Sri Lanka perform relatively strongly, this research into corporate governance, CSR and firm performance is expected to yield interesting results to fill the gap in knowledge of the relationship between corporate governance practices and firm performance.

1.8 Contribution to Knowledge and the Significance of the Study

The present study will contribute to the existing body of knowledge concerning corporate governance practices and firm performance by examining the corporate governance structures of Sri Lanka, and how these structures can reflect the accountability of the board to shareholders and other stakeholders through firm performance.

In the existing literature, authors have studied the relationships between board structure, corporate governance and firm performance (Abdullah 2004; Daily & Dalton 1998; Dalton et al. 1998; Laing & Weir 1999; Zahra & Pearce 1989) and corporate reporting and firm performance (Balabanis, Philips & Lyall 1998; McGuire, Sundgren & Schneeweis 1988; Orlitzky, Schmidt & Rynes 2003; Zairi &

Peters 2002). However, the relationships between corporate governance, board structure, corporate reporting and firm performance have not been investigated in a single study in previous research. In addition, studies of the above relationships in the particularly unstable situation of Sri Lanka have not been studied in the existing literature. This study will, therefore contribute to knowledge as discussed below:

1) This will be the first study to be carried out in a highly volatile environment on corporate governance practices in relation to board structure and corporate reporting practices and their affect on firm performance.

2) Currently this will be the first study that considers the effects of corporate governance practices in the area of CSR reporting on the value of firms in a developing market, which is subject to political instability but high growth prospects.

3) This study also contributes to agency theory and stakeholder theory in relation to the accountability of the board to shareholders and other stakeholders of firms operating in unstable political and economic environments, through the adoption of good governance practices resulting in better management, hence increased performance.

4) The studies in the past mainly examined board structure and firm performance or CSR and firm performance. Currently, there is no study in Sri Lanka focusing on the relationship between board structure, corporate reporting practices and the value of the firm. This is the first study that analyses relationships between board structures, CSR reporting and firm performance, through corporate governance practices recommended in the code of best practice in Sri Lanka, CSR practices reported in the annual reports and firm performance indicators of accounting and market based measures.

5) Prior research in emerging markets was conducted in countries such as Malaysia, Indonesia, Thailand, India and Taiwan, which are in the higher echelon of economic performance. Sri Lanka is a country in South East Asia with a strategic geographical

and economic significance and high potential for development. Its economy has been strongly affected by internal wars with a balance of payment deficit due to high military expenditure, apart from macroeconomic problems that are common to other countries within the emerging markets. Therefore it is important to understand how corporate governance practices affect firm performance in such markets.

Investigation of corporate governance in a developing country such as Sri Lanka is important. Strong performance of the Colombo Stock Market has attracted local and foreign investors, which has resulted in increased interest in good corporate governance, providing improved access to sources of capital and resulting in the economic development of the country even in a volatile environment. Board structure can make a substantial contribution to corporate governance resulting in effective reporting practices through the concept and goal of sustainable development, which will increase the value of firms. Therefore this study will provide a new perspective in studying the relationship between corporate governance practices of board structure, corporate reporting and firm performance.

This study will not only benefit the corporate sector of Sri Lanka, but it will be of significance for other South East Asian countries that are culturally and politically similar to Sri Lanka. It will also benefit investors, decision makers, regulators and researchers as well as assist the policy makers to set new and improved standards for best practices. It will be of significance to academics as the new framework will be a useful future research tool to assess corporate governance and firm performance in developing countries.

1.9 Outline of the Thesis

The thesis comprises eight chapters, beginning with Chapter 1 which introduces the topic and provides the background to the study.

Chapter 2 provides an account of literature on corporate governance practices, corporate reporting and firm performance and limitations in the literature

Chapter 3 explains the economic and political environment of Sri Lanka, as well as its historical development in corporate governance, corporate governance reforms, development of capital markets and corporate reporting practices.

Chapter 4 provides the conceptual framework of corporate governance and firm performance. The literature in the Conceptual framework shows the relationships among those concepts. This chapter will discuss theoretical perspectives of the conceptual framework, which is then used to develop the hypothesis to test the model for corporate governance variables.

Chapter 5 explains the methodology used in the study, which includes selection of the sample and the data collection method. This chapter will also discuss the variables used to measure, conceptualize and operationalize the hypothesis, and includes a discussion of the statistical techniques employed to analyze the data.

Chapter 6 discusses the results of the statistical analysis of the data. Here, descriptive statistics will compare the compliance of corporate governance practices in Sri Lanka. Correlation will measure the strength of association and an analysis of variance will test the hypothesis in the study and explain the interaction between the corporate variables and firm performance variables. Finally, a discussion of the integrated results of the statistical techniques will be used to explain the hypothesis of the study.

Chapter 7 discusses implications of the statistical analysis in relation to corporate governance practices and firm performance of listed companies in Sri Lanka. This discussion will incorporate theoretical and empirical evidence from literature on corporate governance and firm performance. This chapter will also discuss the recommendations.

Chapter 8 reports the summary and conclusions of the study and particularly it provides an overview of the conclusions on the relationships between corporate governance practices and firm performance. It will also discuss the findings, implications, limitations and future research directions.

Chapter 2

Corporate Governance, Corporate Reporting and Firm Performance

2. 1 Introduction

Corporate governance has attracted a great deal of public attention because of its importance to the economic health of companies and its effect on society in general (Rezaee 2009). As it has significant implications for the growth prospects of an economy, numerous recent corporate failures around the world and in Sri Lanka have alerted regulators to the importance of sound corporate governance for the efficient operations of capital markets. This is because implementation of proper corporate governance practices reduces the risk for investors, attracts investment capital and improves corporate performance (Rezaee 2009).

In order to more fully understand corporate governance in Sri Lanka, a review of relevant literature is necessary. In discussing a framework for corporate governance the OECD principles state:

> *The corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets (OECD 2004, p. 17).*

Nestor and Thompson (2000), concede that there are a wide variety of corporate governance regimes in OECD countries. However, the effectiveness of these different forms of corporate governance systems may be influenced by factors such as product market competition, structure of the capital and labour markets, and regulatory and legal environment.

Due to the globalisation of the equity market in the 1980s, governments opened the markets to foreign investors who were diversifying their portfolios to reduce risk. In response to these developments, firms around the world and in Sri Lankan began to restructure their operations to increase shareholder returns. They redefined their management relations with foreign shareholders and revised management compensation to align with global investor interests. At the same time company executives were mastering new leadership skills suitable for operating in environments where small numbers of large international stockholders existed. This internationalization has also resulted in institutional investors discovering higher returns and lower risks outside their home markets. Consequently, increased monitoring by the institutional investors, is now pressing for world standards of corporate governance in the emerging markets (Clarke 2004), because it has identified good corporate governance as a key factor which affects institutional investors willingness to invest in emerging markets (Gibson 2003).

2.2 Corporate Governance

Corporate governance in developed market economies has been built gradually over several centuries as a consequence of the economic development of industrial capitalism (Chowdary 2003). The Dutch East India Company in the seventeenth century was the first company with a diffuse share capital of more than 1,000 investors. In the 19^{th} Century, the technological advances and the expansion of the markets, increased the scale and complexity of the enterprises requiring additional capital (Clarke 2004). As a result, different corporate governance structures evolved in different corporate forms to pursue new opportunities or resolve new economic problems.

Today corporate governance is complex and mosaic, consisting of laws, regulations, politics, public institutions, professional associations and a code of ethics. However, in the emerging markets of the developing countries many details of these structures are missing. For them developing a system of good corporate governance is difficult because such governance is complex and vague due to the confusing relationships between state and financial sectors, weak legal and judicial systems, absent or underdeveloped institutions, corrupt political systems, and scarce human resource capabilities (Chowdary 2003), which can negatively affect the return on investment (Dallas & Bradley 2002).

Corporate governance comprises several elements of the structure of the government, which includes capital, labour, market, organisation along with their regulatory mechanisms. It also involves the processes that connect the structures with agents, including management control and accountability, as well as rules, regulations, laws and institutionalized procedures and norms (Alawattage & Wickramasinghe 2004). However, governance is more than board processes and procedures, involving relationships between management, boards, shareholders and other stakeholders such as employees and the community (Bain & Band 1996; Chowdary 2002). Shleifer and Vishny (1997) view corporate governance as a set of mechanisms which ensures that potential providers of external capital receive a fair return on their investment, because the ownership of firms is separated from their control.

Corporate governance regimes are distinguished between the outsider system and the insider system. The outsider system prevails in market-based economies such as USA, UK, Australia, Canada and other countries, that are characterized by dispersed ownership with strong and liquid securities markets, advanced legal and regulatory frameworks, high disclosure standards, market transparency and market for corporate control, which is the ultimate disciplining mechanism. The insider system prevails in relationship-based economies such as countries in Europe and Asia that are characterized by a concentrated ownership model with controlling shareholders, moderately liquid or weak securities markets, low transparency and disclosure standards, and dependent on loans from banks and support from close business networks (Banks 2004; Clarke 2007). The firms that operate in the market-based economies are supported by regulations through corporations law, stock exchange regulations and corporate governance guidelines, in contrast to the relationship-based economies of the emerging markets which lack robust regulation for their proper functioning (Banks 2004).

Due to the diversity of governance systems, research has tended to focus on the economic effects of particular governance mechanisms. Cadbury (1992) argues that:

The country's economy depends on the drive and efficiency of companies. The effectiveness in which the boards discharge their responsibilities determines their competitive position. They must be free to drive their companies forward, but exercise that freedom within a framework of effective accountability (Cadbury 1992, p. 11).

2.2.1 Definitions of Corporate Governance

Corporate governance is not easy to define as a result of the perpetually expanding boundaries of the subject (Roche 2005). Definitions vary according to the context and the cultural situations (Armstrong & Sweeney 2002) and the perspectives of different researchers. Some schools of researchers argue that a firm's responsibility is primarily towards maximizing the wealth of the shareholders (Friedman 1970; Sundaram & Inkpen 2004), whereas other schools argue that a firm has an obligation, not only to its shareholders, but to all stakeholders whose contribution is necessary for the success of the firm (Donaldson 1983; Freeman 1984). Even though the themes are similar, differences emerge in the practical application of corporate governance in each individual company. The primary mission of public companies is to create long-term value, which is accomplished through corporate governance structures. This mission is classified into value creation and value protection. In relation to value creation, the focus is on shareholders through the development of long-term strategies for sustainable performance, whereas the value protection goal concentrates on accountability in relation to the management and monitoring of a company to protect the interests of both shareholders and stakeholders (Rezaee 2009). The following definitions reflect the above schools of thought.

According to OECD principles corporate governance is a system by which business corporations are directed and controlled. The corporate governance structures specify 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 provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance (OECD 1999).

In 2001, a broader definition offered by OECD was:

> *Corporate governance refers to the private and public institutions, including laws, regulations and accepted business practices, which together govern the relationship, in a market economy, between corporate managers and entrepreneurs (corporate insiders) on one hand, and those who invest resources in corporations, on the other (OECD 2001, p. 13).*

However, corporate governance is considered to have wider implications, which are critical to economic and social well-being and stability and equity of a society. This is captured in the broader definition stated by Adrian Cadbury. He defines corporate governance in line with the stakeholder approach:

> *Corporate governance is concerned with holding the balance between economic and social goals, and between individual and communal goals. The governance framework is there to encourage efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align nearly as possible the interest of individuals, corporations and society. The incentive to corporations is to achieve their corporate aims and to attract investment. The incentive for the state is to strengthen their economies and discourage fraud and mismanagement.(Cadbury 2000)*

Convergence of a regional corporate governance system around common international principles has resulted in fundamental differences in how the values and objectives of the firms are interpreted leading to a focus on shareholder returns or to serve a wider stakeholder interest leading to the ultimate goal of business being more socially and environmentally sustainable (Clarke 2007). Therefore Clarke's (2007) definition of corporate governance involves "balancing complex interests in the pursuit of value creation for the benefit of a wide constituency".

Rezaee (2009) defined corporate governance as "a process through which shareholders induce management to act in their interest, providing a degree of confidence that is necessary for capital markets to function effectively".

2.2.2 Principles for Corporate Governance

The governance structures referred to in the previous section are based on corporate governance principles. There is no globally accepted set of principles that can be applied to board structures (Rezaee 2009). The principles of corporate governance have been developed as guidelines rather than rules which could be used across different countries and markets (Gul & Tsui 2004b).

The Cadbury Code (1992) emerged as a result of the corporate failures of the 1980s. It recommended changes to the board structures and procedures to make the firm more accountable to the shareholders, suggesting an increase in the number of independent directors on the board, separation of the chairman and CEO, and introduction of board committees (Chowdary 2002).

OECD principles of corporate governance (1999) revised in 2004 were intended to assist governments in their effort to evaluate and improve legal, institutional and regulatory framework for corporate governance in their countries. The above principles also provide guidance in developing good corporate governance for those interested. Even though cultural and institutional differences exist between countries, the underlying principles may allow a more fundamental compatibility. The OECD principles relate to equitable treatment, responsibility, transparency and

OECD principles states:

> *Principles focus on governance problems that result from the separation of ownership and control. The degree to which corporations observe basic principles of good corporate governance is an increasingly important factor for investment decisions. Of particular relevance is the relation between corporate governance practices and the increasingly international character of investment. (OECD 2004, pp. 12-3)*

The OECD principles have been designed to be adaptable to different circumstances, cultures and traditions in different countries (Chowdary 2002). These principles cover five areas: protect the rights of shareholders; equitable treatment of all shareholders; recognize the role of shareholders; timely and accurate disclosure and transparency; and responsibilities of the board towards the company, shareholders and stakeholders (OECD 1999). They underpin development of a strong governance framework that will promote transparent and efficient markets (Chowdary 2002). These OECD principles were published in 1999 as non-binding guidelines intended to provide a basis for corporate governance in different countries (Deegan 2004; Gul & Tsui 2004a).

In 2006, the OECD issued the methodology for assessing the implementation of the OECD principles on corporate governance. It states:

…to ensure the basis for an effective corporate governance, the framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.(OECD 2006, p. 27).

These principles were adopted by the International Corporate Governance Network (ICGN), which was founded in March 1995, for their members to take into account when making investment decisions. The ICGN affirms, in addition to the financial criteria, investors should take into account the governance criteria in their decisions to allocate their investment capital (ICGN 2005)

The Australian Securities Exchange (ASX) corporate governance council issued its principles of good corporate governance and best practice recommendations in March 2003 and a revised edition in 2009. It states that corporate governance is a system by which companies are directed and managed. It influences how the objectives of the companies are set and achieved, how risk is monitored and assessed, and how performance is assessed. According to Recommendation 2 of the ASX corporate governance principles, companies should have a board of an effective composition, size and commitment, to adequately discharge its responsibilities and duties. It also states the majority of a board of a listed company must be independent and the role of the Chair and the CEO should not be exercised by the same individual (ASX Corporate Governance Council 2003). The ASX guidelines have been criticized as to whether a majority of independent directors is the best way to serve the interest of the shareholders and Connors (2003) suggests that the issue of independence is highly overrated”. In August 2007 the second edition of the principles was released. These guidelines applied to all listed companies for the financial year 2008.

2.2.3 Benefits of Corporate Governance

The effectiveness of corporate governance depends on the application of these principles in a manner which benefits stakeholders, as well as broader industries and economic sectors. Benefits to stakeholders include resolving conflicts of interest, instilling controls and a sense of ethics, and enforcing and encouraging transparency.

Corporate governance promotes efficient use of resources within the firm and the larger economy. It also helps firm's to attract low cost investment capital through improved investor and creditor confidence, both nationally and internationally. It also increases the firms' responsiveness to the need of the society and results in improving long-term performance (Gregory & Simms 1999).

Good governance promotes firm-wide efficiency and a fair return for investors'. Furthermore, good governance can also benefit a company through better flow of funds and improved access to low cost capital, strong internal controls and discipline, and might achieve better credit ratings which would lead to lower debt funding and higher stock price valuation which can result in equity dilution when additional stock is floated. Companies that are properly governed are supported by deep and transparent financial markets, robust legal systems, and efficient resource allocation. This in turn promotes financial and economic stability and increases national and global growth rates, whereas poorly governed companies do the opposite (Banks 2004).

According to (Keong 2002) good corporate governance brings better management and prudent allocation of the company's resources, and enhances corporate performance which would significantly contribute to the company's share price, increasing the value of a shareholder's holdings.

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2.3 Theoretical Perspective of Corporate Governance

Corporate governance is of growing importance, particularly with regards to the monitoring role of the board of directors. As a result, the theoretical perspectives that are relevant to this study are based on the governance structures and reporting practices that affect the value of the firms. This section reviews the theoretical perspectives of a board's accountability that is relevant for this study. It draws on agency theory, stewardship theory, stakeholder theory, social contract theory, legitimacy theory and resource dependency theory.

2.3.1 Agency Theory

Much of the research into corporate governance derives from agency theory. Since the early work of Berle and Means (1932), corporate governance has focused upon the separation of ownership and control which results in principal-agent problems arising from the dispersed ownership in the modern corporation. They viewed corporate governance as a mechanism where a board of directors is an essential monitoring device to minimize the problems brought about by the principal-agent relationship. In this context, agents are the managers, principals are the owners and the board of directors act as the monitoring mechanism (Mallin 2004). Furthermore, literature on corporate governance attributes two factors to agency theory. The first factor is that corporations are reduced to two participants, managers and shareholders whose interests are assumed to be both clear and consistent. A second notion is that humans are self interested and unwilling to sacrifice their personal interests for the interests of the others (Daily, Dalton & Cannella 2003).

The seminal papers of Alchian and Demstez (1972) and Jensen and Meckling (1976), describe the firm as a nexus of contracts among individual factors of production resulting in the emergence of the agency theory. The firm is not an individual but a legal fiction, where conflicting objectives of individuals are brought into equilibrium within a framework of contractual relationships. These contractual relationships are not only with employees, but with suppliers, customers and creditors (Jensen & Meckling 1976). The intention of these contracts is that all the parties acting in their self interest are motivated to maximize the value of the organization, reducing the agency costs and adopting accounting methods that most efficiently reflect their own performance (Deegan 2004).

The agency role of the directors refers to the governance function of the board of directors in serving the shareholders by ratifying the decisions made by the managers and monitoring the implementation of those decisions. This role has been examined in a large body of literature (Baysinger & Butler 1985; Baysinger & Hoskisson 1990; Daily & Dalton 1994; Fama & Jensen 1983; Lorsch & MacIver 1989). Much of this research has examined board composition due to the importance of the monitoring and governance function of the board (Barnhart, Marr & Rosenstein 1994; Bhagat & Black 1998; Daily & Dalton 1994; Gales & Kesner 1994; Kiel & Nicholson 2003; Pearce & Zahra 1992), because according to the perspective of agency theory the primary responsibility of the board of directors is towards the shareholders to ensure maximization of shareholder value.

The focus of agency theory on the principal and agent relationship (for example shareholders and corporate managers) has created uncertainty due to various information asymmetries (Deegan 2004). The separation of ownership from management can lead to managers of firms taking action that may not maximize shareholders wealth, due to their firm specific knowledge and expertise, which would benefit them and not the owners, hence a monitoring mechanism is designed to protect the shareholder interest (Jensen & Meckling 1976). This emphasizes the role of accounting in reducing the agency cost in an organization, effectively through written contracts tied to the accounting systems as a crucial component of corporate governance structures, because if a manager is rewarded for their performance such as accounting profits, they will attempt to increase profits which will lead to an increase in bonus or remuneration through the selection of a particular accounting method that will increase profit.

Arising from the above is the agency problem on how to induce the agent to act in the best interests of the principal. This results in agency costs, for example monitoring costs and disciplining the agent to prevent abuse (Shleifer & Vishny 1997). Jensen and Meckling (1976) define agency cost as: the sum of monitoring expenditure by the principal to limit the aberrant activities of the agent; bonding expenditure by the agent which will guarantee that certain actions of the agent will not harm the principal or to ensure the principal is compensated if such actions occur; and the residual loss which is the dollar equivalent to the reduction of welfare as a result of the divergence between the agents decisions and those decisions that would maximize the welfare of the principal. However, the agency problem depends on the ownership characteristics of each country. In countries where ownership structures are dispersed, if the investors disagree with the management or are disappointed with the performance of the company, they use the exit options, which will be signaled through reduction in share prices. Whereas countries with concentrated ownership structures and large dominant shareholders, tend to control the managers and expropriate minority shareholders in order to gain private control benefits (Spanos 2005).

The agency model assumes that individuals have access to complete information and investors possess significant knowledge of whether or not governance activities confirm to their preferences and the board has knowledge of investors preferences (Smallman 2004). Therefore according to the view of the agency theorists, an efficient market is considered a solution to mitigate the agency problem, which includes an efficient market for corporate control, management labour and corporate information (Clarke 2004).

According to Johanson and Ostergen (2010) even though agency theory provides a valuable insights into corporate governance, its' applicability is to countries in the Anglo-Saxon model of governance as in Sri Lanka.

Various governance mechanisms have been discussed by agency theorists in relation to protecting the shareholder interests, minimizing agency costs and ensure alignment of the agent-principal relationship. Among the mechanisms that have received substantial attention, and are within the scope of this study, are the governance structures (Davis, Schoorman & Donaldson 1997).

2.3.2 Stewardship Theory

In contrast to agency theory, stewardship theory presents a different model of management, where managers are considered good stewards who will act in the best interest of the owners (Donaldson & Davis 1991). The fundamentals of stewardship theory are based on social psychology, which focuses on the behaviour of executives. The steward's behaviour is pro-organizational and collectivistic, and has higher utility than individualistic self-serving behavior and the steward's behavior will not depart from the interest of the organization because the steward seeks to attain the objectives of the organization (Davis, Schoorman & Donaldson 1997). According to Smallman (2004) where shareholders wealth is maximized, the steward's utilities are maximised too, because organisational success will serve most requirements and the stewards will have a clear mission. He also states that, stewards balance tensions between different beneficiaries and other interest groups. Therefore stewardship theory is an argument put forward for firm performance that satisfies the requirements of the interested parties resulting in dynamic performance equilibrium for balanced governance.

Stewardship theory sees a strong relationship between managers and the success of the firm, and therefore the stewards protect and maximise shareholder wealth through firm performance. A steward who improves performance successfully, satisfies most stakeholder groups in an organization, when these groups have interests that are well served by increasing organisational wealth (Davis, Schoorman & Donaldson 1997). When the position of the CEO and Chairman is held by a single person, the fate of the organization and the power to determine strategy is the responsibility of a single person. Thus the focus of stewardship theory is on structures that facilitate and empower rather than monitor and control (Davis, Schoorman & Donaldson 1997). Therefore stewardship theory takes a more relaxed view of the separation of the role of chairman and CEO, and supports appointment of single person for the position of chairman and CEO and a majority of specialist executive directors rather than non-executive directors (Clarke 2004).

2.3.3 Stakeholder Theory

Research into corporate governance also discusses the stakeholder theory in relation to firms' responsibility to the wider community. A stakeholder is any group of individuals who can affect or is affected by the activities of the firm, in achieving the objectives of the firm (Freeman 1984). A similar view has been put forward by the World Business Council for Sustainable Development (1999), which also identifies stakeholders as the representatives from labor organisations, academia, church, indigenous peoples, human rights groups, government and non-governmental organizations and shareholders, employees, customers/consumers, suppliers, communities and legislators. According to Ansoff (1965), a firm's objective could be achieved through balancing the conflicting interests of these various stakeholders. Therefore, a fundamental aspect of stakeholder theory is to identify the stakeholders an organization is responsible for. Any stakeholder is relevant if their investment is, in some form, subject to risk from the activities of the organization (Clarkson 1995).

Corporate governance systems are in a state of transition due to internationalization of capital markets, resulting in convergence of the shareholder value-based approach to corporate governance and the stakeholder concept of corporate governance towards sustainable business systems (Clarke 1998). It can be seen that stakeholder theory is an extension of the agency perspective, where responsibility of the board of directors is increased from shareholders to other stakeholders' interests (Smallman 2004). Therefore, a narrow focus on shareholders has undergone a change and is expected to take into account a broader group of stakeholders such as those interest groups linked to social, environmental and ethical considerations (Donaldson & Preston 1995; Freeman 1984; Freeman, Wicks & Parmar 2004). As a result stakeholder theory supports the implementation of CSR and endorses risk management policies to manage diverse interests.

Criticisms that focus on stakeholder theory identify the problem of who constitutes genuine stakeholders. One argument is that meeting stakeholders interests also opens up a path for corruption, as it offers agents the opportunity to divert the wealth away from the shareholders to others (Smallman 2004). But the moral perspective of stakeholder theory is all stakeholders have a right to be treated fairly by an organization, and managers should manage the organization for the benefit of all stakeholders, regardless of whether the stakeholder management leads to better financial performance (Deegan 2004).

2.3.4 Resource Dependency Theory

Lawrence and Lorsch (1967) link the resource dependency theory to corporate governance. They state that successful organizations possess internal structures that match environmental demand, which links to Pfeffer's (1972) argument that board size and composition is a rational organisational response to the conditions of the external environment. Furthermore, directors may serve to connect the external resources with the firm to overcome uncertainty (Hillman, Cannella Jr & Paetzols 2000), because coping effectively with uncertainty is essential for the survival of the company. According to the resource dependency role, the directors bring resources such as information, skills, key constituents (suppliers, buyers, public policy decision makers, social groups) and legitimacy that will reduce uncertainty (Gales & Kesner 1994). Thus Hillman et al. (2000) consider the potential results of linking the firm with external environmental factors and reducing uncertainty is the reduction of transaction cost associated with external linkage. This theory supports the appointment of directors to multiple boards because of their opportunities to gather information and network in various ways.

2.3.5 Social Contract Theory

Among the other theories reviewed in corporate governance literature social contract theory, sees society as a series of social contracts between members of society and society itself (Gray, Owen & Adams 1996). There is a school of thought which sees social responsibility as a contractual obligation the firm owes to society (Donaldson 1983). Integrated social contract theory was developed by Donaldson and Dunfee (1999) as a way for managers to make ethical decision making, which refers to macrosocial and microsocial contracts. The former refers to the communities and the expectation from the business to provide support to the local community, and the latter refers to a specific form of involvement.

2.3.6 Legitimacy Theory

Another theory reviewed in corporate governance literature is legitimacy theory. Legitimacy theory is defined as "a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate with some socially constructed systems of norms, values, beliefs and definitions” (Suchman 1995). Similar to social contract theory, legitimacy theory is based upon the notion that there is a social contract between the society and an organisation. A firm receives permission to operate from the society and is ultimately accountable to the society for how it operates and what it does, because society provides corporations the authority to own and use natural resources and to hire employees (Deegan 2004).

Traditionally profit maximization was viewed as a measure of corporate performance. But according to the legitimacy theory, profit is viewed as an all inclusive measure of organizational legitimacy (Ramanathan 1976).

The emphasis of legitimacy theory is that an organization must consider the rights of the public at large, not merely the rights of the investors. Failure to comply with societal expectations may result in sanctions being imposed in the form of restrictions on firms operations, resources and demand for its products. Much empirical research has used legitimacy theory to study social and environmental reporting, and proposes a relationship between corporate disclosures and community expectations (Deegan 2004).

2.4 Board Structure

Boards can be structured in many different ways to meet the needs of the organization. The variation in governance structures reflects two competing views. Firstly, it is believed that boards are formed to maximize the managerial control of the firm through adopting structures that will allow for control of the board by management, resulting in superior performance due to the inside information and better understanding of the needs of the firm than is possible with outside independent directors (Berle & Means 1932; Mace 1971) The second view is that boards are formed to minimize agency costs through adoption of structures that require ratification and monitoring of management behaviour by outside directors, thus reducing the difference between shareholders and management interest (Fama, Eugene F 1980; Fama & Jensen 1983). These two views are clearly on the opposite ends of the corporate governance spectrum, however, most firms have governance structures which fall between these two extremes and incorporate both managerial control and outside director monitoring (Petra 2007). External investors consider corporate governance as a significant factor which affects their investment decisions, because appropriate governance structures reduce risks and promote performance (Davis 2002). The governance structures that are considered in this study are board leadership, board composition and board committees.

2.4.1 Board Leadership Structure

An important mechanism of board structure is its leadership, which is reflected in the positions of chairman and CEO. Combined leadership structure occurs when the CEO wears two hats, one as the CEO and the other as the chairman. Cadbury (2002) refers to this as combined leadership. Alternatively, separate leadership is when two different people occupy the positions of chairman and CEO (Rechner & Dalton 1991). Review of the literature on corporate governance base their theoretical justifications on different views of agency theory and stewardship theory, which are both applicable to leadership structure. Separation of the role of CEO and chairman is largely grounded in the agency theory (Dalton et al. 1998), because the role of the board of directors is to monitor management to protect the interests of the shareholders (Fama & Jensen 1983). However, combining the roles of the CEO and the chairperson, will result in a dominant CEO which will lead to ineffective monitoring of the management by the board (Lam & Lee 2008). Conversely, advocates of stewardship theory argue that managers are inherently trustworthy and are good stewards of firm resources and work to attain a higher level of corporate profits (Donaldson & Davis 1991, 1994). An advantage of combining the two roles is that it strengthens the leadership (Suryanarayana 2005). There is research supporting combined leadership structure is related to ROA (Dehaene, De Vuyst & Ooghe 2001). They find that a combined leadership structure has a significant impact on ROA. A possible explanation for this significant relationship is that the chairman, who is also active as CEO in the day to day activities of the firm, will try to invest as much as possible to increase the size of the firm as well as their personal status. As long as the growth in investment increases the return of the firm, they will invest positively. Similarly, studies by Donaldson and Davis (1991) found firms relying on combined structures attained higher shareholder returns measured by return on equity which led to support for the stewardship theory.

The existence of the board a based on the need for management to be accountable for the vast discretionary power it yields. If the chairman and CEO are the same person, this makes management accountable to a body led by management. Therefore separating the role is believed to lead to a more objective evaluation of the CEO, creating an environment of greater accountability (Monks & Minow 2004). According to Suryanarayana (2005), another advantage of the appointment of an independent chairman is that he/she brings experience in running similar businesses or handling the functions of finance, as well as the independence, objectivity and dispassionate views needed on crucial matters. A separation of the two roles seems to be a prudent and effective means of ensuring proper focus and also eliminating potential errors and conflict of interest that may arise as a result of combining the roles (Banks 2004). Banks also states that it is an enormous job for one person to hold dual roles requiring much time and commitment. Therefore the separation of the two roles, for example with a CEO who is running the executive team and daily corporate activities which require enormous time and commitment, and the chairman who is running the board of directors, ensuring effective execution of oversight and strategy, reduces mistakes, neglect and potential conflict of interest. In addition, a separate leadership structure provides potential benefits and costs to the firm (Brickley, Coles & Jarrell 1997). The benefits of a separate structure include management and control, whereas the costs include information asymmetry, inconsistent decisions and compensations to maintain two positions.

The code of best practice published by the Cadbury committee in December 1992 recommended separation of these two most powerful posts on the board of directors, namely the Chairman and CEO. The issue raised by Cadbury was that the CEO is responsible for the day to day running of the company, whereas the Chairman's role was to ensure that the board works effectively and therefore involves monitoring and evaluating the performance of executive directors and the CEO (Laing & Weir 1999). Rechner and Dalton (1991) also supported the above view of separating the roles, stating that combined role is frequently cited as an important factor that influences companies that decline. Daily and Dalton (1993a) support this view, stating that combining the roles is a sign of strong CEO power, which may have a negative consequence for corporate performance. According to Jensen and Meckling (1976), vigilant boards favour separate leadership because combined leadership provides CEOs with formal authority that is undivided, and promotes CEO entrenchment which can lead to opportunistic and inefficient behaviour reducing shareholder wealth. Studies by Dechow et al. (1996) report that firms which manipulate earnings are likely to have combined leadership structures. Alternatively, when the roles are separated, CEO compensation is lower (Core, Holthausen & Larcker 1999).

According to Suryanarayana (2005), leadership is a matter of how the board functions, whether there is one person or two persons at the top. It is the efficacy of the other members of the board that determines if these two roles should be separated or combined. However, the post of chairman and CEO requires different skills and abilities, but both positions do require leadership skills. The chairman needs to have a strategic sense, the ability to analyse and understand and foresee changes in the business environment. In contrast, the CEO's role is to formulate and implement the strategy and also requires making right things happen at the right time, which is to run the company as it stands today, whereas the chairman's responsibility is to create tomorrow's company out of today's.

Therefore, separation of the two roles is believed to lead to more objective evaluation of the CEO and also creates an environment of more accountability, because the very existence of the board is based on the need for accountability (Monks & Minow 2004).

2.4.2 Board Composition

Another important mechanism of board structure is the composition of the board, which refers to executive and non-executive director representation on the board. Both agency theory and stewardship theory apply to board composition. Boards dominated by non-executive directors are largely grounded in agency theory. According to agency theory, an effective board should be comprised of a majority of non-executive directors, who are believed to provide superior performance due to their independence from firm management (Dalton et al. 1998). In contrast, a majority executive director representation on the board is grounded in stewardship theory, which argues that managers are good stewards of the organization and work to attain higher profits and shareholder returns (Donaldson & Davis 1994).

An effective board should comprise of majority of non-executive directors (Dalton et al. 1998). However, executive director's responsibility is the day-to-day operation of the business such as finance and marketing, etc. They bring specialised expertise and a wealth of knowledge to the company (Weir & Laing, David 2001). As they are subordinates of the CEO, they are not in a position to monitor or discipline the CEO (Daily & Dalton 1993b). Therefore it is important to have a mechanism to monitor the actions of the CEO and executive directors (Weir & Laing, David 2001).

Cadbury (1992) identifies the monitoring role as the key responsibility of the non-executive directors. They may become less effective monitors as the length of their service increases as they build close relationships with executive directors (O'Sullivan & Wong 1999). This supports Cadbury's claim that the independence of non-executive directors may diminish as the tenure of the board increases (Bhagat & Black 1998; Dalton et al. 1998; Yarmack 1996).

If the representation on the board of non-executive directors increased the effectiveness of monitoring, then the performance of the company should improve. Studies by Fama (1980) and Fama and Jensen (1983) indicate that non-executive directors have more incentive to protect the interest of the shareholders, because of the importance of maintaining their reputation in the market for outside directorships. Therefore, independent directors are considered valuable by the regulators due to their importance of better monitoring. Beasely (1996) reports that boards with a majority of outside directors fulfill their monitoring role in respect to financial reporting.

Empirical evidence regarding firms' performance and board composition is mixed. It is believed that outside directors provide many advantages. They also bring in a wide breadth of knowledge, expertise and contacts, which may enhance the ability of management to secure scarce external resources, as well as the independence they have from the CEO (Kesner & Johnson 1990). Firms with a higher proportion of outside directors are likely to replace the CEO after a period of poor performance of the company (Weisbach 1988). Similarly, outside directors are likely to join boards after a poor performance or leave when a shift in strategy requires new or additional outside guidance (Hermalin & Weisbach 1988). Some studies find that there is a positive link between firm performance and board composition. Lee et al. (1992) and Rosentein and Wyatt (1990) state that boards dominated by independent outside directors are associated with substantially higher abnormal returns. There are others which state that having more outside directors on the board, increases performance (Barnhart, Marr & Rosenstein 1994; Daily & Dalton 1992; Schellenger, Wood & Tashakori 1989). There is also evidence which indicates that the percentage of inside directors is high on boards of declining firms (Pfeffer 1972). Studies by Valenti et al (2011) reports that during periods of declining performance number of outside directors would be affected. Conversely, when performance improves firms were able to add more outside directors. According to Baysinger and Butler (1985), the degree of financial health is affected by the board composition. They also find that boards with a higher percentage of outside directors have an above average performance compared to firms with a lower number of non-executive directors.

Alternatively, there are studies which show a negative relationship between the proportion of outside directors and corporate performance (Bhagat & Black 1998).
Weir and Lang (2001) state that there are a number of reasons why empirical evidence may not support the positive relationship between non-executive directors and performance. Non-executive directors are only employed on a part-time basis and are likely to have other work commitments, which may result in devoting insufficient time to the company. They may lack the expertise required to understand certain technical issues in the business and they may not possess sufficient information when called upon to make key decisions.

Accordingly, lack of time, the absence of an appropriate level of expertise (Zahra & Pearce 1989), and fear of challenging difficult decisions made by management (Lorsch & MacIver 1989) are some of the arguments which inhibit the effectiveness of non-executive directors' contribution to corporate performance.

There are other studies which suggest that there is no link between outside independent directors and firm performance. MacAvoy et el. (1983) do not find any support for the hypothesis that a board's composition affects firm performance. Fosberg (1989) and Molz (1988) did not find any link between outside independent directors and performance. However, the composition of the board and not its size, is important for firm performance. Hence, the argument for the board composition is that the skills and the knowledge base they bring to the firm is of importance to firm performance (Bonn, Yoshikawa & Phan 2004).

2.4.3 Board Committees

Board committees are also an important mechanism of the board structure providing independent professional oversight of corporate activities to protect shareholders interests (Harrison 1987). The agency theory principle of separating the monitoring and execution function is established to monitor the execution functions of audit, remuneration and nomination (Roche 2005). Corporate failures in the past focused criticism on the inadequacy of governance structures to take corrective actions by the boards of failed firms. Importance of these committees was espoused by the business world (Petra 2007). As a result the Cadbury Committee report in 1992, recommended that boards should nominate sub-committees to address the following three functions:

- audit committees to oversee the accounting procedures and external audits;
- remuneration committees to decide the pay of corporate executives; and
- nominating committees to nominate directors and officers to the board;

These named committees can be just a window dressing unless they are independent, have access to information and professional advice, and contain members who are financially literate (Keong 2002). Therefore, the Cadbury committee and OECD principles recommended that these committees should be composed exclusively of independent non-executive directors to strengthen the internal control systems of firms (Davis 2002; Laing & Weir 1999).

Shareholders are able to have greater confidence in boards when there are named committees to address the key responsibilities and disclose their existence to the investors (Davis 2002). As a result most countries are moving towards including these committees to enhance independence and satisfy their regulatory requirements. Sarbanes-Oxley of 2002, the New York Stock Exchange, NASDAQ, ASX, as well as the Colombo Stock Exchange adopted changes to their listing rules to include audit, remuneration and nomination committees (Petra 2007).

Studies by Lorsch and MacIver (1989), Daily (1994, 1996) and Kesner (1988) explain that most critical processes and decisions are derived from a board subcommittee such as audit, remuneration and nomination committees, rather than boards-at-large. These committees enable the boards to cope with the limited time factor and the complexity of information that they need to deal with (Dalton et al. 1998).

Board accountability and better quality financial reporting were seen important as a result of the financial scandals of the 1980s. Empirical evidence regarding the relationship between audit committees and the reliability of financial information is mixed. Firms with an audit committee are more likely to have reliable financial information. In contrast, Beasley (1996) reports that firms with audit committees do not increase the reliability of information. Audit committees with a greater percentage of non-independent directors reported lower probability of issuing going concern reports by the auditor (Carcello & Neal 2000). However, evidence indicated that there is a positive effect on the quality of financial statements with the presence of independent audit committees (Petra 2007). Therefore, improved auditor independence was seen as vital as was the placement of non-executive directors as a buffer between an external auditor and management (Spira & Bender 2004) through audit committees.

Under the agency theory, the principal-agent relationship leads to utility maximizing behavior of the agent, which has attempted to base management compensation on firm performance, for example on net income or market valuation (Petra 2007). Prior research indicates that CEO compensation is reduced when the board exercises control over firm decision-making (Boyd 1994). This supports the view that the boards, which monitor management decisions, are able to keep CEO compensation under control. Therefore earnings informativeness is seen to be positively associated with independent remuneration committees.

- Nomination committees assist the board of directors to nominate members to fill new or vacant positions on the board, which will reduce the involvement of board members, including the CEO from the nomination process to the board (Petra 2007). Benefits of nomination committees are that they will appoint individuals who will act as advocates of shareholders (Byrd & Hickman 1992).

Roche (2005) states that in order to balance the power of the CEO, Asian firms have created board committees to strengthen the monitoring function of the board. An important aspect of the board committees is their ability to remove the CEO when the firm performance is poor. As a result of the importance of monitoring function of the board, board committees are an important governance structure.

2.5 Corporate Reporting

Corporate reporting is an important mechanism of corporate governance that represents board accountability. It is considered that the board of directors is accountable to shareholders and other stakeholders who are affected by the activities of the firm (Deegan 2004; Rezaee 2009). The purpose of corporate reporting is disclosure of information useful to those stakeholders who have an active interest in the organization (Zairi & Letza 1994). It provides society-at-large with information about the extent to which the organization has met the responsibilities imposed upon it (Gary, Owen & Maunders 1991). An accountability model explained by Gary, Owen and Adams (1996) states that accountability involves responsibility to undertake certain actions and responsibility to provide an account of those actions, so that reporting is assumed to be responsibility-driven rather than demand-driven.

Corporate reporting includes financial reporting and information beyond what regulations require companies to provide to their shareholders and other stakeholders (Eccles 2004). It is comprised of mandatory reporting required by regulations such as the Companies Act, accounting standards and stock exchange listing requirements and voluntary disclosures, which vary in the level of disclosure

(Ghazali 2008). The governance role of accounting information contributes directly to economic performance by managing the resources of the firm efficiently and reducing the expropriation of the wealth of investors by managers. Therefore, financial accounting information is considered to reduce the risk premium demanded by investors to compensate for the risk of losses due to the opportunistic behaviour of managers (Bushman & Smith 2001).

Financial reporting and disclosure are an important means by which management communicate firm performance and corporate governance to outside investors. Corporate disclosures provided through regulated financial reports are important to the functioning of an efficient capital market. The demand for financial reporting and disclosures arises as a result of information asymmetry and agency conflicts between managers and outside investors (Healey & Palepu 2001).

Financial reporting has been criticized for ignoring the externalities caused by the reporting entity, which relate to social and environmental implications (Deegan 2004, p. 305). A large number of scholars take the view that a firm is no longer seen as purely a private institution, but instead as a social institution (Frederick, Post & Davis 1992; Freeman 1984; Lodge 1977) and the firm's responsibility is not only to its shareholders, but to all stakeholders whose contribution is necessary for its success (Balabanis, Philips & Lyall 1998).

A considerable number of studies have investigated the association between corporate characteristics and disclosure levels in annual reports and found that large firms tend to disclose more information as they are more prone to public scrutiny (Firth 1979; Huafang & Jianguo 2007). The size, operation in the manufacturing sector and listings in foreign stock markets induced Japanese firms to disclose more information (Cooke 1992).

According to prior studies, Healy and Palepu (2001) identify three types of capital market effects for firms that make voluntary disclosures: improved liquidity of stocks in the capital market; reduced cost of capital; and increased analyst following.

Therefore they consider that voluntary disclosure reduces the information asymmetry among informed and uniformed investors.

It has been predicted that corporate governance systems which promote corporate transparency and accountability are significantly associated with voluntary disclosures (Huafang & Jianguo 2007). Examination of the impact of board composition on corporate disclosures, as measured by the ratio of independent directors, is positively associated with mandatory disclosures (Chen & Jaggi 2000) and increases in the number of independent directors improves voluntary disclosures (Donnelly & Mulcahy 2008; Huafang & Jianguo 2007). Studies also report that combined leadership structure is associated with a lower level of voluntary disclosures (Gul & Leung 2004; Huafang & Jianguo 2007).

2.5.1 CSR Reporting

CSR reporting involves voluntary disclosure of corporate actions concerning social and environmental issues (Neilsen & Thomsen 2007). Therefore, the role of a corporate report is to inform society of the extent of actions taken by the firm in fulfilling their responsibilities (Deegan 2004).There is increasing pressure on companies to report on CSR activities (Day & Woodward 2009). This is referred to as the process of communicating the social and environmental effects of the economic actions of organisations to particular interest groups within society and to society at large (Gray, Owen & Adams 1996).

CSR is defined as

> *achieving commercial success in ways that honour ethical values and respect for people, communities and the natural environment (Liyanage 2007, p. 28).*

Arising from the above definitions, CSR reporting involves reporting on ethical conduct of the organisation and initiatives which benefit society through measures to minimize harmful effects on the people and the planet, and to give back to society in the belief that it takes a great deal from society in the form of resources and markets (Liyanage 2007).

Currently there is a demand for companies to go beyond financial accountability to shareholders and integrate interests of all stakeholders. CSR reporting arises from the idea of accountability, which is an important concept in corporate governance. The accountability model defined by Gary et al. (1996), involves two responsibilities or duties: the responsibility to undertake certain actions and the responsibility to provide an account of those actions that affect the external environment. According to the accountability model, reporting is assumed to be driven by responsibility rather than demand (Deegan 2004). Furthermore, Zairi and Peters (2002) state that corporate social accountability and reporting is seen as a key driver for engaging the wider community as an important stakeholder in business activity. Therefore, corporate governance is about the duties and responsibilities of the directors to be accountable to all stakeholders.

2.6 Corporate Social Responsibility

If corporate governance is about its relationship with stakeholders, then the organizations activities must be directed towards meeting the needs of various stakeholders. These stakeholders include shareholders, employees, creditors, suppliers, customers, government and the community. Therefore an effective governance mechanism must ensure the interests of all stakeholders are met.

There are several researchers who argue that a business has an obligation beyond profit maximisation and should make a positive contribution to society (Carroll 1999; Fisher 2004). They believe corporations have a variety of social obligations, which range from meeting the regulatory and legal obligations, to philanthropic opportunities such as helping the underprivileged communities and developing countries. The basic idea of corporate social responsibility is that the business and society are interwoven rather than separate entities (Wood 1991). In contrast, according to those who adopt the neo-classical view of the firm, social responsibility is the provision of employment and payment of tax (Moir 2001). This is also emphasized in the OECD principles of corporate governance (OECD 1999) in relation to the importance of achieving social and economic sustainability by creating ample job opportunities in the economy.

The literature identifies a number of theories that explain corporate social responsibility (see Section 2.3). The stakeholder theory explains how, and social contract theory and legitimacy theory explain why CSR is important (Moir 2001).

The literature has also proposed a variety of definitions for corporate social responsibility. Many focus on voluntary actions designed to improve social and environmental conditions (Aguilera et al. 2007; Mackey, Mackey & Barney 2007). A most referred definition on CSR is by the WBCSD (1999). Who define it as “the continuing commitment by business to behave ethically and contribute to the economic development while improving the quality of life of the workforce and their families as well as the local community and society at large”. They also state that CSR is the ethical behaviour of a company towards society. Therefore management must act responsibly in its relationship with other stakeholders who have a legitimate interest in the business and not just the shareholders.

The view that a firm’s social responsibility goes beyond economic or legal responsibility was put forward by Carroll (1991). He defined the concept of CSR as a pyramid which constitutes: economic responsibility to be profitable, the foundation upon which all others rest; legal responsibility to obey the law; ethical responsibility to do what is right, just, fair and avoid harm; and philanthropic responsibility to be good corporate citizens by contributing resources to the community and improving the quality of life. Philanthropy, which is at the top of the pyramid, is a discretionary responsibility.

According to Buhr and Graftstrom (2007), there is a large number of companies who talk about their CSR activities as a critical success factor and refer to CSR as a business policy that creates new market opportunities, competitive advantage and customer satisfaction. It also builds goodwill, improves their reputation, strengthens their brand names and helps companies to attract and motivate employees. They also stated that this argument supports the understanding that CSR is compatible with maximization of profits.

There are many different measures used for corporate social responsibility. Measurement of corporate social responsibility depends on addressing the stakeholders (Wood & Jones 1995). According to McGuire (1988), corporate social responsibility is measured using three criteria: expert evaluation, content analysis of annual reports and other documents, and performance in controlling pollution. A study conducted by Rettab et al. (2008) uses financial performance measures, employee commitment and corporate reputation as measures for corporate social responsibility.

According to a model developed by Mackay and Barney (2007) suggests that managers who seek to maximize the market value of firms in their decision making should provide a standard against which to evaluate economic consequences of engaging in socially responsible activities that may reduce the present value of their cash flow. They state that not all investors are interested in maximizing their immediate dividends. Therefore, the concept of maximizing the present value of firm's cash flow and maximizing the firm's value is not equivalent. If the assumption is that capital markets are semi-strong efficient (Fama 1970), publicly available information is reflected in the market price, and a firm pursues socially responsible activity that reduces the present value of cash flow, then investors may factor those actions and their consequences into their decisions (Mackey, Mackey & Barney 2007).The impacts of socially responsible activities on the market value of firms depends on the supply of and demand for socially responsible opportunities at the time the decisions are made and whether to pursue or cease socially responsible activities (Mackey, Mackey & Barney 2007). A view presented by CalPERS (2009) is that boards that strive for active cooperation between the firm and the stakeholders are likely to create wealth, employment and sustainable economies.

The call for greater stakeholder orientation and the social impact of corporate scandal raised the concern for corporations to act responsibly, to integrate issues relating to corporate social responsibility to the decision-making of corporate boards for responsible corporate conduct (Spitzeck 2009). However, Arora and Dharwadkar (2011) argue that, current level of demand for socially responsible investment is lower than the supply of socially responsible investment. As a result effective governance structures will ensure that managers will act in the best interest of the principal, which suggest that effective governance will reduce positive CSR. According to Turnbull (1994), corporate decision-making can increase efficiency through participation of stakeholders. Therefore de Wit et al. (2006) consider that establishment of the necessary governance structures is important to integrate stakeholder concerns.

2.7 Capital Markets and Corporate Governance

A capital market is the place to issue and trade debt and equity capital, which is important to global financial systems and for the survival and growth of the national economies. Firms may not be able to operate or exist if they are unable to access primary capital, in which case corporate governance would not be relevant as there would be no suppliers of capital (Banks 2004). The economic growth of a business depends on its role in creating safe, efficient and competitive capital markets. The life blood of capital markets is the capital provided by investors, that must be protected through appropriate regulations, effective corporate governance and the optimal market mechanism (Rezaee 2009). Globalization has resulted in the flow of capital from international markets enabling firms to access capital from a much larger pool of investors. To reap the benefits of the global capital markets, and attract long-term capital, corporate governance practices must be credible and well understood across borders. Even if countries do not rely on foreign investments, adherence to corporate governance practices will increase the confidence of the domestic investors, reduce the cost of capital and induce a more stable source of capital (OECD 1999).

Lynn Turner, former chief accountant of SEC in the US states:

> *The ability of US capital markets to attract capital depends on investors having confidence in the integrity and transparency of the markets. Confidence is earned over time through honest and fair markets, and provides investors with the material information they need to make informed decisions. (Turner 2006).*

One of the key drivers of economic growth of a country are investor confidence and its capital markets (Rezaee 2009). The efficiency of the stock market has an important implication for investors and regulatory authorities. Therefore efficiency in information dissemination ensures that funds are allocated to projects that result in higher returns with necessary adjustments to risks (Cooray & Wickremasinghe 2007).

Sustainability of public companies is considered the key to investor confidence, which requires accurate financial reports for investors to make informed investment decisions. Financial information, which is reliable, accurate and transparent, is important to the efficiency, integrity and safety of capital markets. As a result, investors rely on the quality of corporate financial reports in making rational investment decisions. Therefore financial statements are a vital form of information to capital markets and their participants (Rezaee 2009).

Disclosure of information over and above the accounting regulations has benefits in the capital markets. Those items of information that are contained within the annual reports and those that are made via media and press releases and conference calls to security analysts are information that is voluntarily disclosed (Deegan 2004). Firms with more informative disclosure policies tend to have a larger analyst following. Accurate analyst earnings forecasts result in reduced information asymmetry (Lang & Lundholm 1996). Increased voluntary disclosures are associated with low cost of capital (Botosan 1997).

2.8 Firm Performance

Firm performance in the literature is based on the value of the firm. Studies show that corporate governance affects firm value as a result of reduced expropriation by insiders and improvement in the expected cash flows that can be distributed to investors (Black, Jang & Kim 2006; Claessens & Fan 2002; Gomper, Ishii & Metrick 2003; Klapper & Love 2004). Four different approaches to firm value have been identified in the corporate finance literature (Qureshi 2007). They are: the *financial management approach* which focus on the estimation of cash flows and investment levels before identifying and evaluating the impact of financing sources on firm value; the *capital structure approach* which studies the impact of capital structure changes on the value of firm and how different factors impact directly or inversely, the debt and equity component of the firm capital structure; the *resource based approach* which explains the value of firm as an outcome of firm's resources; and finally, the *sustainable growth approach* is a summary of the above three approaches to firm value, taking into account the firm's operating performance, its investment and financing needs, the financing sources, and its financing and dividend policies for sustainable development of firm's resources and maximization of firm value.

Apart from the above factors that increase the firm value, the market for corporate takeovers and market for managers argument assumes that information is produced to minimize the cost of capital, which will result in increasing the value of the firm (Deegan 2004).

According to capital market research, the value of a firm is defined as the present value of expected future cash-flows discounted at the appropriate risk adjusted rate of return (Kothari 2001). Share prices react to the information provided by the accounting systems and reflect information used by the capital markets (Deegan 2004). Efficiency of capital markets and the resulting investor confidence are key drivers of economic growth, prosperity and financial stability. Therefore increased investor confidence results in higher share prices (Rezaee 2009). Share prices and returns are considered to be changes in prices plus dividends. Furthermore, share prices represent a benchmark measure of firm value, while share value represents a benchmark measure of firm performance (Deegan 2004).

According to Crowther (1996) firm performance is determined from the perspective of the stakeholder group by which that performance is considered. Therefore, analysis of the stakeholders enables researchers to identify the perspective of the performance evaluation (Crowther 1996). Referring to the above, Rappaport (1986) considers the shareholder value as the only concern of a firm, whereas Crowther (1996) states that the there seems to be a general acceptance of the importance of a wider stakeholder community.

To evaluate performance, it is necessary to determine the constituents of good performance using performance indicators. To be useful, a performance indicator must be measurable, relevant and important to the performance of the organization, it must be meaningful and the cost of obtaining the information must not outweigh its value (Oakland 1989).

There are many measures of firm performance. Financial measures of firm performance used in empirical research on corporate governance fit into both accounting-based measures and market-based measures (Kiel & Nicholson 2003). Most commonly used accounting based-measures are return on assets (ROA) (Kiel & Nicholson 2003), return on equity (ROE) (Baysinger & Butler 1985) and earnings per share. The most commonly used market-based measures are market to book value ratio and Tobin's Q (Barnhart, Marr & Rosenstein 1994). There is criticism about accounting as opposed to market-based measures. Accounting-based measures can be easily manipulated by the management through changes to accounting methods or accruals and are difficult to interpret across industries. They are historical and report a more backward focus on past success (Kiel & Nicholson 2003), and exclude risks and investment requirements, and time value of money (Rappaport 1986). Market-based measures are based on the value of companies common stock and are often affected by factors beyond the control of the leaders of the firms. They reflect risk adjusted performance and are not adversely affected by multi-industry or multinational contexts (Daily & Dalton 1998). They are considered forward looking and reflects current plans and strategies (Kiel & Nicholson 2003).

Both accounting and market based definitions have been used to analyse the relationship between corporate social responsibility and firm performance (Orlitzky, Schmidt & Rynes 2003). Most social responsibility scholars seem to prefer the market definitions to accounting definitions of firm performance, because market measures seem to understand the ways the social responsible corporate activities can create or destroy shareholder wealth (Margolis & Walsh 2001). Margolis and Walsh also found a positive relationship between corporate social responsibility and financial performance in 95 empirical studies conducted since 1972. Conclusions from the results of their study are that when corporate social responsibility is taken as an independent variable, the firms that do well by doing good contribute to the bottom line. Their interpretation of the results is that when corporate social responsibility is taken as the dependent variable, the firms that make money have the ability to devote their resources to social initiatives.

Results of the study by Haniffa and Hudaib (2006) indicate that a significant relationship exists between the accounting based measures of performance and combined leadership structure. Irrespective of the type of performance measures used, whether accounting-based or the market-based measures, Daily and Dalton (1998) found no systematic relationship between board composition and firm performance.

Empirical evidence of the relationship between measures of firm performance, based on accounting or market based performance indicators, and corporate governance attributes is mixed. There is much debate regarding the most reliable measures. However, in a meta-analytic review of corporate governance literature there appears to be no consensus regarding the efficacy about reliability of one measure over another (Dalton et al. 1998).

Tobin's Q

Tobin's Q is a market-based measure of profitability widely used in corporate governance studies as a proxy for firm performance (Agrawal & Knoeber 1996; Gomper, Ishii & Metrick 2003; Hermalin & Weisbach 1991). It is defined as the ratio of the market value of assets to the replacement value of assets (Bhagat & Jefferis 2002), which shows the financial strength of a company. Min and Prather (2001) states that according to the value additivity principle, the market value of a firm is the net present values (NPV) of the current project carried out by the current management plus the NPV of all future growth opportunities. To increase the market value of the firm, management, must accept projects with a positive NPV. Accepting projects with a positive NPV will cause the market value of the firm to exceed the book value of the firm, which will result in Tobin's Q being greater than one. Tobin's Q is both used in developed and developing financial markets.

It is considered that the higher the value of Q, the more effective are the governance mechanisms and the better is the market's perception of the company's performance.

A higher Q shows how closely the shareholders and managers interests have been aligned, whereas a lower Q suggests greater managerial discretion (Weir, Laing & McKnight 2002). Agrawal and Knoeber (1996) found a significant negative relationship between boards dominated by outsiders and firm performance based on Tobin's Q. Studies conducted by Hermalin and Weisbach (1991) in the US and Weir et al. (2002) in the UK using Q-ratio, found no significant relationship between the proportion of non-executive directors and performance.

Return on Assets

Return on assets (ROA) is also a measure of performance widely used in the governance literature for accounting-based measures (Finkelstein & D'Aveni 1994; Kiel & Nicholson 2003; Weir & Laing 2001). It is a measure which assesses the efficiency of assets employed (Bonn, Yoshikawa & Phan 2004) and shows investors the earnings the firm has generated from its investment in capital assets (Epps & Cereola 2008). Efficient use of a firm's assets is best reflected by its rate of return on its assets. ROA is an indicator of short-term performance which is calculated as net income divided by total assets (Finkelstein & D'Aveni 1994). Since managers are responsible for the operation of the business and utilization of the firm's assets, ROA is a measure that allows users to assess how well a firm's corporate governance system is working in securing and motivating efficiency of the firm's management (Epps & Cereola 2008).

Return on Equity

Another important measure of firm performance used in corporate governance research is eturn on equity (ROE), which is also an accounting-based measure (Baysinger & Butler 1985; Dehaene, De Vuyst & Ooghe 2001). The primary aim of an organization's operation is to generate profits for the benefit of the investors. Therefore, return on equity is a measure that shows investors the profit generated from the money invested by the shareholders (Epps & Cereola 2008). It is defined as the net income divided by common equity.

2.9 Impact of Accounting Information on Share Value

Changes in the share prices indicate that new information is incorporated into the share price through the activities of the investors in the market. An announcement of accounting earnings can impact share prices due to their potential information content. Price changes, in relation to information as it becomes available, have a more significant impact on smaller firms than larger firms. There tends to be more information available for larger firms. As the firm size increases, share prices incorporate information from numerous sources and there is relatively less unexpected information when earnings are announced ultimately (Deegan 2004).

According to modern financial theory, disclosing additional information about projects or strategies of the firm can affect the value of the firm. Hence, the concept of the efficient market hypothesis is that prices react rapidly to information when information becomes available. In an efficient capital market, a semi-strong form holds that all publicly available information will be reflected in the share prices (Bettis 1983). Therefore modern finance theory proposes that, the sum of expected future cash flows from dividends, discounted to their present value using a rate of return commensurate with the firms level of risk, will determine the share price, because dividends are a function of accounting earning which will be paid out of firms past or current earnings (Deegan 2004).

It is generally accepted that the generation of wealth is one of the basic objectives of most commercial organisations. If they fail to create wealth, it will be difficult to raise capital to support their activities, as the creation of value is not only important for the investors, but also for those who manage the organisations (Pirie & Smith 2008). Therefore, it is important for market actors to know how publicly available financial information causes stock prices to change (Dorner 2005). Favourable reactions are evidenced by increases in prices and unfavourable reactions are evidenced by decreases in prices, and no price change around the time of information release implies no reaction to change (Deegan 2004). It is expected that investors (including the future investors) value share prices according to publicly available financial information, mainly based on the information in annual reports. Information in statements hardly gives an explanation of the volatility of the share prices due to the difference in the time of disclosure of information and the publishing of the annual reports. In most cases the market has already incorporated the information through articles, press releases and quarterly financial statements in the stock prices (Dorner 2005). Therefore, firms with higher than expected future earnings will report higher share prices (Deegan 2004).

2.10 Corporate Governance Practices in Emerging Economies

The main reason for emerging economies to consider external corporate governance is the need to build investor confidence to attract foreign and local investment to expand the trade (Abhayawansa & Johnson 2007). International donor agencies such as the IMF and World Bank as well as organizations such as the OECD, indirectly influence developing countries to improve their external corporate governance mechanisms and regulatory infrastructure (Athukorala & Reid 2002). The effects of these changes can be seen in the actions of investors who are increasingly becoming confident in investing in some markets which were considered risky at one stage. However, the corporate sectors in emerging countries do seem to lag behind the benchmark for sound corporate governance (Mobius 2002).

The economic crisis that hit the South East Asian stock markets in 1997-1998 was partly attributed to weak corporate governance in the region, which prompted governments to consider ways of improving governance structures in their countries (Mobius 2002). This resulted in governance reforms in the emerging markets for restoring investor confidence by providing a secure institutional platform to build an investment market(Monks & Minow 2004, p.305). Therefore, codes of corporate governance were established by most of these countries to promote a continuous flow of funds and to boost investor confidence in their capital markets (Haniffa & Hudaib 2006). Even though emerging markets are aware of the concept of corporate governance, implementation of corporate governance practices has not been effective (Mobius 2002). The codes, which were derived from recommendations in developed countries, may not be applicable to developing countries due to their national character, and economic and social priorities. Therefore what is effective in one country may not be so in another. Likewise, every corporation has its unique characteristics due to their history, culture and business goals. Hence all these factors need to be taken into account in their efforts to reform corporate governance (Haniffa & Hudaib 2006).

As the business environment of the developed countries is different from that of emerging countries, the governance structures designed to enhance performance should take into account the unique business environment that exists in the country without blindly adopting the practices from other countries. For example, Haniffa and Hudaib (2006) concluded from a study on Malaysian listed companies, that the applicability of recommendations derived by the Cadbury Report and Hampel Report in the UK may be disputable due to high ownership concentration, close control by owners and substantial shareholders, cross-holdings of share ownership or pyramiding, and the close relationship between the firms, banks and the government.

Corporate governance is affected by the ownership structure of the firm in the emerging markets. The findings from the above Malaysian Study are not unique. The shares of Asian corporations are often tightly held by one or several members of a family and voting rights held by the family is usually higher than their cash flow rights. In addition to family ownership, a significant number of listed companies are controlled by the state in countries such as Singapore and China. Moreover, financial institutions are less common in developing countries in Asia (Claessens & Fan 2002).

In the emerging economies, the quality of public governance determines corporate governance practices. For example, Asian economies are plagued by corruption and rent seeking which has been reported as an important source of corporate profits. Furthermore, with widespread collusion between politicians and entrepreneurs to extract or protect monopoly profits, it is unlikely that high quality corporate governance practices will arise rapidly (Claessens & Fan 2002). There are a number of studies in the emerging markets which have reported that political connections were valued by investors (Fisman 2001; Ramalho 2003).

A study on the linkages between the OECD and emerging South East Asian stock markets reveals that fluctuations in the stock markets in emerging markets are caused by the fluctuations in their own regional markets rather than the fluctuations in the advanced markets (Masih & Masih 1999). However, Cooray and Wickremasinghe (2007) state that stock markets cannot use the share returns of a particular market in the region to predict the returns of others in the South Asian region.

Emerging markets are currently going through a transition stage where a younger and more educated generation is taking over the family businesses. They are not only involved in implementing change dealing with globalisation, culture and family traditions, but are also providing a supportive environment for the successful implementation of corporate governance (Keong 2002).

2.11 Corporate Governance, Capital Markets and Firm Performance

Corporate governance practices referred to previously in this section affect capital market performance, because investors consider firms with good governance in their investment decisions. Efficient capital markets are vital for better performance of public companies. Therefore it is important for investors to have confidence in the capital markets to ensure capital provided by them is protected through effective corporate governance practices (Rezaee 2009).

Corporate governance reforms, which were made in response to major corporate collapses in various stock markets, were the results of efforts to enhance the governance structures through establishing corporate governance guidelines in various countries to increase investor confidence in their capital markets. Among the reports produced on corporate governance reforms were the Cadbury, Hampel, Greenbury and Higgs reports in the UK, the Bosch report in Australia, the Business Roundtable report in the US and OECD Principles of Corporate Governance (Haniffa & Hudaib 2006).

Board Structure and Performance

A review of the existing research which addressed board structure in relation to the director composition and leadership structure, argued that board structure can influence a variety of organizational outcomes (Daily & Dalton 1994, 1995; Dalton et al. 1998; Donaldson & Davis 1991; Laing & Weir 1999). Corporate reform efforts by institutional investors and shareholder activists are the results of these governance issues (Davis & Thompson 1994). Hostile takeovers in the late 1980s, moved institutional shareholders to intervene with boards of under-performing companies in order to promote best practice guidelines covering board structure and composition (Baxt, Ramsay & Stapledon 2002). As a result, major US stock exchanges (New York Stock Exchange, Nasdaq Stock Market and American Stock Exchange) initiated governance reforms to create a system to control management action to reduce the principal-agency problems and enhance performance (Brown & Caylor 2009). These reformists strongly argue that boards should be comprised predominantly, if not exclusively, of independent directors with the separation of CEO and the chairperson positions, despite the fact that the review of academic literature as to the superiority of board composition or board leadership structure and firm performance is unclear (Dalton et al. 1998).

The results of a study conducted in the UK by Weir and Lang (2001) on companies that complied with the governance structures, recommended by the Cadbury Committee did not find a relationship between the recommended structures and performance based on accounting-based measure of ROA. They found that the best performing firms have the lowest incidence of Cadbury preferred governance structures comprising of the separation of the CEO and the chairman, and boards comprising of majority of non-executive director representation and board committees. However the poorest performing firms tend to adopt the preferred governance structures. They state that it is important to recognize that an appropriate structure for one firm may not be suitable to the other. There should be greater flexibility in adopting an acceptable governance structure that will promote shareholder interests of maximization of shareholders wealth.

Leadership Structure and Firm Performance

The literature indicates mixed results regarding combined leadership structure and firm performance. It has been argued by both theorists (Fama & Jensen 1983) and regulators (Cadbury 1992; Higgs Report 2003), that the separation of the roles of CEO and Chairman is an important determinant of board effectiveness. Agency theorists argue that the same person holding the CEO and chairman roles simultaneously will reduce effectiveness of board monitoring, whereas the argument put forward by stewardship theorists is that one person holding both roles may improve performance, as such a structure removes any internal and external ambiguity regarding responsibility for firm processes and outcomes (Finkelstein & D'Aveni 1994). A study conducted by Daily and Dalton (1992) reported no relationship between combined leadership structure and performance indicators, and Rechner and Dalton (1991) also reported that a firm which had a separate leadership structure indicated higher performance than firms with combined leadership structures.

The announcement of separation of roles of Chairman and CEO has a positive effect on share prices (Dahya, Lonie & Power 1996). Evidence also indicates that when the two positions are separated, firms are valued highly by the market, because the market believes that monitoring of the CEO by the Chairman, strengthens internal control of the firm (Petra 2007; Yarmack 1996).

Non-executive Directors and Firm Performance

Empirical evidence reports mixed results in relation to the proportion of non-executive directors and firm performance. However appointment of non-executive directors is widely accepted. Studies conducted by Rosentein and Wyatt (1990), concluded that appointment of outside directors results in significant and positive share price reactions. Companies which are dominated by non-executive directors are more likely to remove the CEO if their entity’s performance is poor (Boeker 1992), and they are also likely to initiate restructuring if the performance declines (Perry & Shivadasani 2001). Studies by Hillman and Dalziel (2003), Pfeffer and Salancik (1978) and Yoshikawa & McGuire (2008) report that the expertise and knowledge non-executive directors bring to the firm and the resource dependence role which allows them to provide advice and resources, help the firm to perform better. Peng (2004) also found that institutional outside directors impact positively on firm performance, which implies the effective resource role played by them.

Alternatively, the literature also provides arguments against the effectiveness of outside directors. Lack of time and appropriate expertise of outside directors (Zahra & Pearce 1989) and their fear of challenging difficult decisions made by management (Lorsch & MacIver 1989) does not contribute to corporate performance. Managers become risk averse due to the performance evaluation by outside directors resulting in concentrating on short-term investments at the expense of strategic investments that benefit the companies in the long run (Gunasekerage & Reed 2008). Baysinger and Hoskisson (1990) also report that the ability to contribute to strategic decisions is limited for boards dominated by outside directors. According to Abdullah (2004), outside directors could adversely affect board performance largely due to the fact that they do not have access and adequate knowledge about the firm.

The results of the study by Haniffa and Hudaib (2006) indicated that the market measure of performance based on Tobin's Q or accounting measures of performance based on ROA and board composition were not significantly related to performance. However, the results of the findings of Hermalin and Weisbach (1991) and Weir, Laing et al. (2002) supported market measures of performance and Mehran (1995) and Klein (1998) support accounting measures of performance. Furthermore, positive and significant stock market reactions were reported to the announcement of poison pill defences when the boards have a majority of independent directors (Brickley, Coles & Terry 1994).

Board Committee and Performance

The literature on corporate governance reports that well-governed firms should have boards consisting of monitoring committees of audit, remuneration and nomination, to enhance corporate accountability by providing a mechanism for independent oversight of firms' activities; thus leading to more responsible behavior by corporate boards and to the protection of the interests of the shareholder (Harrison 1987).

Research on the relationship between board committees and corporate performance is scarce (Dalton et al. 1998). However, an investigation of board sub-committees and firm performance by Klein (1998) revealed evidence that the presence of remuneration committees was positively related to firm performance, but the relationship was not strong. On the other hand, Petra's (2007) in his study on board structures composed of audit, remuneration and nomination committees was not associated with earnings informativeness to the stock market performance, and Weir and Laing et al. (2002) found audit committee structure had no effect on firm performance.

CSR and Performance

The view that the singular objective of a firm is the maximization of shareholders wealth is reflected in the argument put forward by Friedman (1970), "business has only one social responsibility and that is to use it resources and engage in activities designed to increase its profits so long as its stays within the rules of the game", in other word engage in open and free competition without deception or fraud.

An alternative argument is that the socially responsible behaviour of a firm can improve the present value of firm's cash flow, because a socially responsible firm can differentiate its product in the market, reduce firms' exposure to risk and avoid fines imposed by the government. These would be consistent with the maximising the wealth of the company's long-term equity holders (Mackey, Mackey & Barney 2007).

Empirical studies on the relationship between CSR and firm performance report inconclusive results, which are positive, negative or neutral (McWilliams & Siegel 2000). A meta-analysis by Margolis and Walsh (2001) reported 55% these studies identified a positive relationship between CSR and financial performance, 22% reported no relationship, 18% found mixed relationships and 4% reported a negative relationship. Similar results were reported by Orlitzky et al. (2003). McGuire (1988) and Nelling and Web (2009) did not find any relationship between CSR reporting and stock market performance. CSR programmes cost money to the firm. However, by treating CSR as a business function, a company can control the costs and balance the needs of the business community and affordability to the firm (Shahin & Zairi 2007). There is also an emphasis that CSR needs to be considered as any other investment (Castka, Bamber & Sharp 2004). But the rationale for CSR engagement must be communicated to stakeholders (Hartman, Rubin & Dhanda 2007), otherwise it may not have an impact on firm performance. As a result of this possible unawareness, CSR activities in emerging markets may have a negative impact on performance (Mellahi & Wood 2003).

2.12 Limitations of Existing Literature and Motivation for the Study

From the above discussion, the limitations identified in the literature on the relationship between board leadership structure, composition, committees, corporate reporting practices and firm performance can be summarised.

There is significant research on corporate governance both in developed and developing countries. The focus of existing literature is mainly on corporate governance characteristics and firm performance, or corporate governance and CSR reporting, or CSR reporting and firm performance.

Although there are several studies conducted on the relationships between corporate governance practices of board leadership structure, composition, committees, corporate reporting practices and firm performance, few have explored these issues in developing countries, especially in countries experiencing the unique situations such as that found in Sri Lanka. Furthermore, studies which include CSR reporting as good corporate governance practice in the developing countries where economic development is low, is an important aspect of the performance of the capital markets. In Sri Lanka, the performance of the capital markets did not reflect the difficult political and economic situation.

Sri Lanka is a developing country which was affected by ongoing internal wars and a natural disaster in the period under review. Therefore the government’s ability or resources to take part in this development is limited. Yet, the focus on developing and transforming the institutions needed to engage the poor in market activities are increasing in Sri Lanka. The responsibility for this role rests with the government. But where the government structures are weak or corrupt as is often the case with developing countries, other such as the private sector institutions takes over (Mair & Marti 2007), which shows that the boards accountability to other stakeholders may have an impact on firm performance.

Corporate governance in Sri Lanka is still in the development stage compared to the western world. Literature on corporate governance in Sri Lanka is also limited. There are no previous studies conducted on corporate governance practices and firm performance in Sri Lanka. Currently this is the only study being conducted in Sri Lanka on corporate governance practices of board leadership structures, composition, committees and corporate reporting practices and firm performance. The relationship between board leadership structures, composition, committees and corporate reporting practices on firm performance is not well defined, nor analysed in existing literature. This study will fill the gap by assessing the relationship between good corporate governance practices of separate leadership, non-executive director representation in the board, board committees, corporate social reporting and performance based on the capital market performance.

2.13 Conclusion

This chapter reviewed the literature in relation to corporate governance practices in both developed and developing countries. Research shows that the mission of most organizations is to maximize shareholder value in the short term at the expense of long term interests which tend to overshadow the long term opportunities, especially where management may be motivated to move up the executive ladder through maximum gains in minimum time (Zairi & Letza 1994). The literature also recognized that a structure that is appropriate to one organization may not be suitable for another, and if shareholder interests are to be promoted, greater flexibility in acceptable governance structures may be necessary (Weir & Laing, David 2001). Prior research also reported good governance could help investors to have confidence in companies resulting in capital market performance. However, studies of corporate governance and firm performance relationships reported mixed results. The literature identified that corporate governance practices and firm performance has not been studied in highly volatile environments such as Sri Lanka, where stock markets are resilient to volatility in the environment. This chapter also reviewed the theories that are relevant to corporate governance practices in this study. This literature review will be used to design the conceptual framework to develop the relevant hypotheses in this study.

Chapter 3

Economic Environment, Corporate Governance and Development of Capital Markets in Sri Lanka

3.1 Introduction

Corporate governance is of critical importance to the economy of Sri Lanka. It is small, market orientated, open and continuously faces global, political and economic shocks, in addition to the threat of terrorism and natural disasters. The emergence of South Asia as a new force in the world economy suggests that Sri Lanka will benefit by achieving higher economic growth. Furthermore, it is fast integrating with the global capital markets, so savings and investments have to be encouraged to strengthen the economy (Cabraal 2008). For successful economic restructuring and long-term development, Sri Lanka requires an efficient capital market capable of mobilising domestic savings and channelling them into the most productive uses. To establish such a market, good corporate governance is considered essential (WTO 2004). Developing countries rely on foreign investment and trade for economic growth. The top criteria used by international investors in evaluating the investment potential are legal and accounting infrastructure, fraud risk and corporate governance. Therefore, to build investor confidence, developing countries need to undertake reforms of corporate governance, financial reporting and related laws (Abhayawansa & Johnson 2007).

The chapter is structured to describe the impetus for development of corporate governance in Sri Lanka. Section 3.2 presents an overview of the political and economic environment, which has a remarkable influence on the investments by local and foreign investors and the share prices. Section 3.3 discusses the development of capital markets. Section 3.4 explains early corporate governance in Sri Lanka followed by corporate governance reforms in Section 3.5. Section 3.6 describes corporate governance practices. Section 3.7 discusses corporate reporting practices and Section 3.8 discusses corporate social responsibility reporting practices. The relationship between corporate governance, capital markets and firm performance in Sri Lanka are discussed in Section

3.9. Finally, Section 3.10 discusses the characteristics of the top 50 listed companies in Sri Lanka followed by the conclusion in Section 3.11.

3.2 Overview of Political and Economic Environments in Sri Lanka

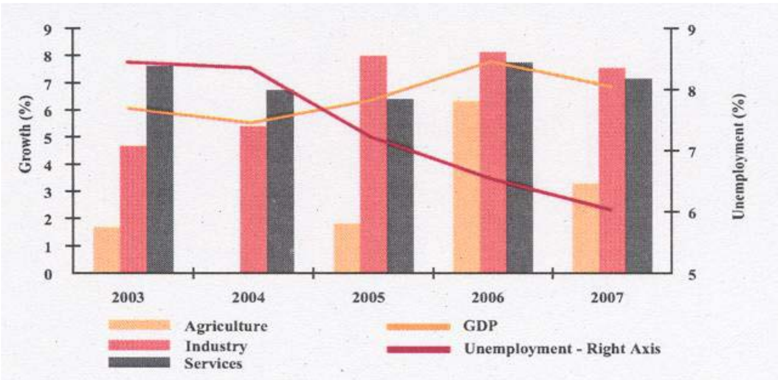
Sri Lanka is a developing economy with a population of 19.5 million. It has a highly developed institutional framework. At the time of independence in 1948, three primary developmental objectives driving economic policy were: to achieve a reasonable rate of economic growth, greater equity and greater self reliance or national control over economic activities. During the 1960s and early 1970s, maximization of growth was focused on issues of poverty and equality. Developmental thinkers in the 1950s and early 1960s were influenced by external conditions of development, which were to increase growth through industrialization based on import substitution. In the 1960s and 1970s with the rise of a nationalistic political ideology, there was a marked shift towards inward looking policies, which emphasized import substitution as a viable strategy of economic development. A change of government in 1977, resulted in the introduction of economic reform that encouraged strategic policies reflecting outwardly oriented growth adhering to a more laissez-faire approach to economic policy (Weerakone 2004), such as liberalization of trade, devaluation of the exchange rate, policy measures for attracting foreign direct investment (FDI) and encouraging the private sector, dismantling price controls and a massive public investment programme (Balasooriya, Alam & Coghill 2008). The initial phase of the reform process (1977-1989) focused on economic growth. However, it did not have a profile for welfare strategy. Their emphasis was in the allocation of public sector expenditure for infrastructure development to support private sector and rural development to address the poverty issues through growth and employment. The policy centred on three projects financed by foreign aid: irrigation and power development, infrastructure for the Free Trade Zone project and the Housing and Urban Development programme (Gunetilleke 2000).

This development was severely hampered in 1983 as a result of ethnic violence and insurgency. However, the second phase in the reform process (1989-1994) resulted in macro policy reforms in the financial sector and capital market reforms, fiscal reforms, foreign exchange reforms, trade policy reforms and privatization and private sector promotion measures. The socio-economic impact of these reforms emphasized, poverty alleviation. A political change in the government in 1994 did not have a major impact on the economic policy. It was a continuation of previous policies with greater intensification of privatisation (Gunetilleke 2000).

In 2007, the Sri Lankan economy recorded a growth rate of above 6 per cent for the third consecutive year since independence with the lowest ever recorded unemployment of 6 per cent. Per capita gross domestic product (GDP) increased from 3.9 per cent in 2002 to 5.9 per cent in 2003 (Figure 3.1 and Table 3.1). The factors that impacted positively on overall economic growth were improved macroeconomic conditions, a continued ceasefire and the peace initiatives, declining interest rates, increased capital flows, support from foreign donors, falling inflation, favorable weather conditions and stable foreign exchange markets in 2003. In 2007, per capita GDP increased to 6.8 per cent(Figure 3.1 and Table 3.1) amidst a number of serious challenges, including adverse weather conditions, high international oil prices and the unfavourable security situations, which is a reflection of the economy's resilience to adverse shocks the country had to face during the year.

Figure 3.1

Economic Growth and Unemployment



Source: Central Bank of Sri Lanka Annual Report 2007.

Table 3.1

Key Economic Indicators of Sri Lanka, 2003-2007

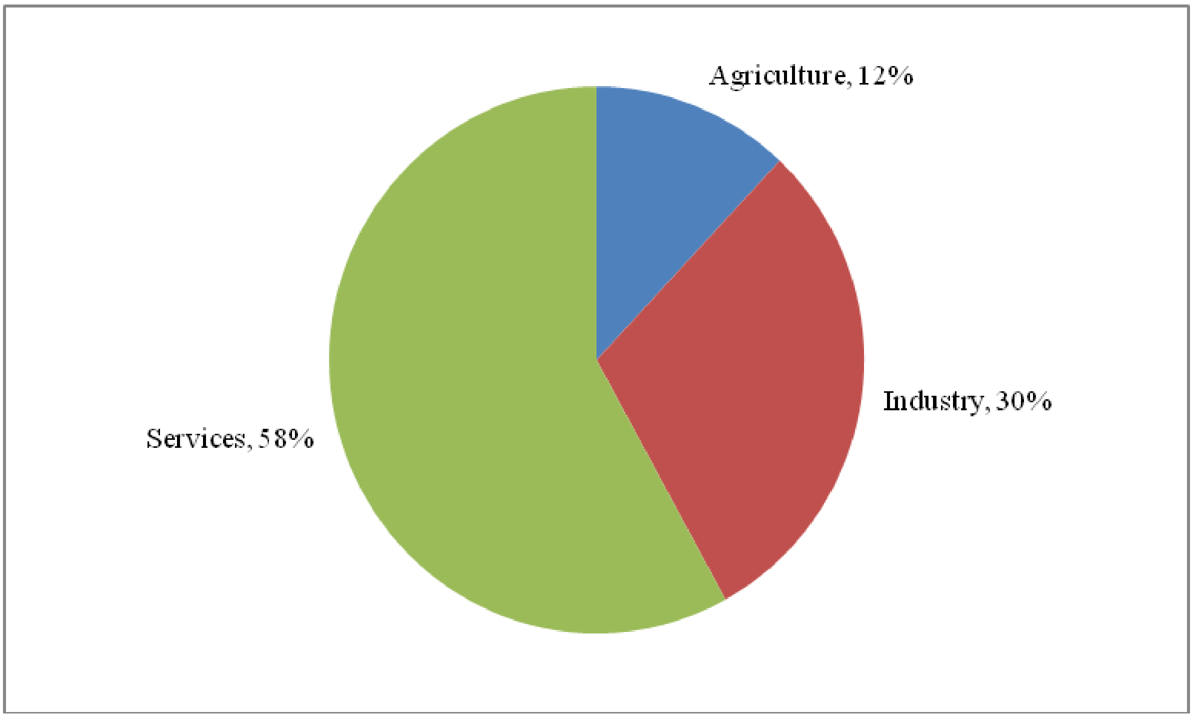
Economic Indicators	**2003**	**2004**	**2005**	**2006**	**2007**
GDP%	5.9	5.4	6.2	7.7	6.8
Inflation	6.3	7.6	11.6	13.7	17.5
Private Sector Investment	19.2	22.5	22.4	23.9	22.5
Trade Balance	-1539	-2243	-2516	-3371	-3560
Unemployment	8.4	8.3	7.2	6.5	6
Market Capitalisation (Rs.billion)	263	382	584	835	821
All Share Price Index	1062.1	1506.9	1922.2	2722.4	2541
Listed Companies	244	241	241	237	236

Source: LMD 50 2007/2008

In the past Sri Lanka was dependent on tea, rubber and coconut as its primary products, but in the recent past, growth in the industrial sector consisted of textiles, apparel and leather products, food beverages and tobacco, chemical, rubber, plastics and petroleum products. But the service sector (Figure 3.2) seemed to be the driving force behind Sri Lanka's economic expansion (Institute of Policy Studies 2007). The private sector in Sri Lanka is fast developing in terms of productivity. It plays an important role in the economy of the country. However, difficulties faced by the private sector in the period under review (2003 and 2007), have taken their toll on the economy due to the civil war. The location of Sri Lanka in South Asia places it in competition with the strongest industrial countries in the region such as India, Pakistan and China. So the biggest share of the regional trade will be by India, Pakistan and China (Ariyabandu & Hulangamuwa 2002).

Figure 3.2

Structure of the Economy, 2007



Source: Central Bank of Sri Lanka Annual Report 2007

Liberalization of the economy is evident since 1977, as Sri Lanka gradually moved away from a state controlled economy to a private sector-led economy, which spurred the rapid emergence of capital markets resulting in serious market reforms. This created the need to keep up with the financial development taking place outside the region, particularly in the bond and securities market (Weerakone 2004).

3.3 Development of Capital Markets in Sri Lanka

The importance of corporate governance in Sri Lanka emerged with the commencement of share trading in Sri Lanka in 1896 to finance the tea plantations under the Colombo Share Brokers Association (CSBA) (Wickremasinghe 2007). The requirement of funds for the development of the plantation industry was the primary objective of the colonial rulers for initiating share trading in Colombo. In 1904, CSBA changed its name to Colombo Brokers Association. By 1948 there were 140 listed companies of which 120 were from the plantation sector.

Following independence in 1948, private sector participation in the economy was low. Government policies for nationalisation of the private sector organisations encouraged public sector participation in the economy. Consequently, by 1976 the number of listed companies dropped down to 76. Liberalisation in the economy in 1977 resulted in Sri Lanka adopting more open market orientated policies, which led to the growth of private sector participation and capital market development in the late 1980s. The country depended on foreign direct investment to develop the infrastructure and fuel economic growth. In 1985, the Colombo Stock Exchange (CSE) was incorporated, which marked a milestone in the history of share trading in Sri Lanka. Currently there are 236 companies listed representing 20 business sectors. Market capitalization increased from Rs 263 billion in 2003 to Rs 824 billion in 2007, which corresponds to approximately 30% of country's gross domestic product (The LMD 50 2008). The CSE was reported as one of the best performing markets in the world (Sri Lanka Today 2009).

Some of the contributing factors for the CSE's high performance were the declining interest rates for savings, high economic growth and a high profile share offering. With the declining interest rates and the negative real rates, there was a temptation to invest in more risky stocks that offered higher return on investment compared to fixed income savings instruments by the investors. Even though investor confidence was affected by intermittent terrorist activity, the stock market performance was resilient. Dips in the stock market performance due to heightened terrorist activity, which were followed by the upward trends, probably reflected the increasing dominance of local investors who account for nearly two thirds of the turnover of the CSE. These local investors seem to have factored in conflict-related uncertainties on the economy (Institute of Policy Studies 2007).

Sri Lanka was the first country in the Indian subcontinent to pursue economic liberalisation and it has continued deregulation of the financial sector (Peagam 1995). Since 1990, Sri Lanka has lifted the controls on foreign banks and foreigner's investment in equities and dismantled foreign exchange controls. In addition, Sri Lankan authorities have introduced the creation of mutual funds, merchant banks, venture capital companies, joint venture brokerage firms with foreign partners and central depository system for paperless money.

Capital Market Performance

Prerequisites for the efficient market hypothesis are the availability of information freely, competition among investors and effective communication among market participants. The CSE has addressed these and many other related issues. The studies conducted by Abeysekera (2001) and Wickremasinghe (2007), indicated that stocks traded in the CSE do not behave in a manner consistent with the weak form of the efficient market hypothesis. According to Abeysekera (2001), the emerging stock markets are not as informationally efficient as the developed country stock markets. Therefore it is not unreasonable to expect the CSE to have a lower level of information efficiency than a well developed market due to the fact that CSE has experienced tremendous changes in culture and operations as a result of organizational and technological changes.

The companies listed in the CSE have recorded a steady growth rate of 20% over the last number of years despite the war. Resilience of the corporate sector is clearly evident in these results (Singapulli et al. 2009).

The equity market in 2003 showed a record performance. On the Colombo Bourse, the all share price index (ASPI) appreciated by 30% at the end of 2003, which was mainly influenced by the peace process and subsequent peace talks between government and the Liberation Tigers of Tamil Elam (LTTE), towards a stable political environment. A successful donor conference, tax amnesty, a low interest rate scenario and economic development were followed by strong corporate earnings. These all indicated the aggressive investment opportunities available in the securities market in Sri Lanka (Securities and Exchange Commission of Sri Lanka 2003).

The Colombo stock market was buoyant in the first quarter of 2007, due to lower interest rates, inflation and better performance of the corporate sector. But from the middle of the second quarter there was a decline in activity due to a volatile political and security environment as well as rising inflation and interest rates (Securities and Exchange Commission of Sri Lanka 2007). Yet the ASPI increased significantly from 1062.1 in 2003 to 2541 in 2007 (Table 3.1).

By the end of the three decade old war in May 2009, the Colombo stock market reported record earnings. It was one of the best performing stock markets in the world. The performance of the stock market is attributed to the peaceful conditions prevailing in Sri Lanka, fall in bank interest rates and the rapid drop in inflation. Market capitalisation reached a record high of Rs. 1000 billion in October 2009. Increase in capitalization in the stock market is a sign that the development in the country is favourable. The end of the internal conflicts has also contributed to the improvement of the economic environment, leading to an increase in tourist arrivals and an inflow of foreign funds (Daily News 2009).

Historically, Sri Lankan stocks have traded at a lower value compared to other emerging markets such as Vietnam and Egypt, due to Sri Lanka experiencing an internal war which increased the political risks of the country. However, as a result of the end of the war, country risk declined sharply. Corporate earnings were resilient and robust in the past despite the uncertainty that prevailed in Sri Lanka. Therefore, in the present, environment stocks should be valued on par or higher than other emerging markets (Singapulli et al. 2009). In October 2009, Reuters reported CSE as the best performing stock market in the world for the year to date (Daily News 2009).

3.4 Early Corporate Governance in Sri Lanka

Governance is defined as the structure and functions of a corporation in relation to its stakeholders (Banks 2004). The origin of corporate governance goes back prior to colonization, when Sri Lanka was a centralized kingship state. The political state, civil state and economy were converged into feudal governance. The king was the ultimate owner of the land. The governance structure was supported by a well defined caste system. Each caste was a well defined occupation or a profession. The governance structures, based on castes were hierarchically defined. The lowest levels were the labourers and the highest ranks were the landowners known as the aristocracy and the king. The focus of the government was the society at large, not the enterprise. This was because the economic activities were organised within the framework of the castes, which was an extension of the family. Processes and contents of governance were inscribed in the structures of castes. The organising principle for the use of the land and the crafts was the caste system. Upper castes monitored the performance of economic activities and the criteria for monitoring and controls were also rituals (Peiris 1956). Performance itself was the maintenance of rituals, rather than meeting explicit output targets, and despotism was directed against the violation or avoidance of rituals.

From the 18th Century onwards, imperialism penetrated into the feudal society. The Portugese, Dutch and British saw Sri Lanka as a place for investment. Its location was also central to traders. Imperialism transformed the kingship into a colonial state. But it did not result in the dissolution of pre-colonial feudal governance. Instead it incorporated it to serve the objectives of colonial mercantilism. Plantation-based mercantilism was also the result of imperialism (Alawattage & Wickramasinghe 2004). Economic monitoring and direction of the plantations were in the hands of Agency Houses and British citizens contributed capital through the London stock market. However, interest in corporate governance in Sri Lanka emerged as a result of the development of capital markets when Sri Lanka shifted from socialist to market-orientated policies in 1977.

3.5 Corporate Governance Reforms

Investors consider corporate governance to be among the top criteria in their investment decisions. The factors that drive regulatory reforms in corporate governance of countries like Sri Lanka and India are foreign investment and trade (Abhayawansa & Johnson 2007). Competition for capital globally and the mature status of the capital markets in Sri Lanka have also boosted interest in corporate reforms in Sri Lanka. Furthermore, since the late 1980s corporate failures in Sri Lanka have also increased the attention on proper corporate governance, which is fundamental to the efficiency of the operation of capital markets.

Despite its highly qualified accountants who are capable of providing a world class service, non compliance in both accounting and auditing practices in Sri Lanka is attributed to inadequate regulatory practices (World Bank 2004). It is hoped that the introduction of the new Companies’ Act of 2007, corporate governance best practices and auditing and accounting standards will result in improving the previous regime for those shareholders who were deprived of their rights due to lack of accountability and transparency.

Legal Reforms

The legal framework is a key element of the corporate governance system of a country, which shows that accountability and transparency cannot be achieved unless there are appropriate rules and regulations in place. It provides legal protection for investors and ensures their ability to exercise their rights (Gul & Tsui 2004a). La Porta et al. (1997) found evidence that the operation of a country's capital markets depends on the legal environment.

The legal system of Sri Lanka is a mixture of common law and civil law due to the influence of Dutch and British colonization. The legal framework for corporate control was provided by the *Companies Act* of Sri Lanka, enacted in 1982, which was based on the 1948 *Companies Act* of the United Kingdom. The act had many provisions that encouraged good corporate governance and dealt extensively with disclosures in the annual financial statements of companies. It included conduct of board proceedings, conduct of shareholder's meetings, and particulars regarding proxies, directors' reports, responsibilities of directors, auditors functions etc. It also set out the provisions relating to the winding up of companies, consolidation procedures and also processes connected to borrowings by companies. Even though the provisions were not modern the act provided a useful framework, which laid the foundation for the new act enacted in 2007.

The new *Companies Act No. 7* was enacted in 2007 to keep abreast with prevalent international laws and to safeguard the interest of all stakeholders including directors, major shareholders, minority shareholders and creditors. The act introduced greater protection to minority shareholders, directors' duties, and transparency and accountability. The new *Company Act No. 7* was based on Canadian, New Zealand and other modern practices. It became operative for all listed companies from 1st April 2007, and was mandatory from 1st April 2008.

In addition to the companies Act, Securities and Exchange Commission of Sri Lanka Act No 36 of 1987 as amended by Act No. 26 of 1991, Act no.18 of 2003 and Act No 47 of 2009, is the principal legislation governing the securities market in Sri Lanka. It provides the regulatory framework for the operation and regulation of the stock market and created the establishment of the Securities and Exchange Commission (SEC) of Sri Lanka for the purpose of regulating the securities market in Sri Lanka. The first amendment to the Act, in 1991 empowered the SEC to Grant licenses to stock exchanges, managing companies in respect of each unit trust, stock brokers and stock dealers who engage in the business of trading in securities; to register market intermediaries, to setup a compensation fund, and matters connected there with or incidental to thereto (Securities Exchange Commission of Sri Lanka 2011). The second amendment to the Act in 2003 provided to broadened the investigative powers of the SEC. It also brought five additional categories of market intermediaries (underwrites, margin providers, credit rating agencies, investment managers and clearing houses) under the registration and regulation authority of SEC. Furthermore the amendment to the SEC Act in 2009 allowed for the regulation of derivatives, empowered the SEC to issue directives to listed companies and also provide for private sector representation in SEC (eStandardsForum 2010).

Sri Lanka witnessed many corporate failures in the late 1980s and early 1990s through to 2008, especially in the finance companies. The weak financial reporting and auditing structures were some of the underlying causes of these failures. According to Cobham and Subramanium (1998), lack of rigorous accounting standards and auditing control in developing countries may create a relatively higher information asymmetry among stakeholders than in major developed countries.

Accounting Reforms

In 1992, the Institute of Chartered Accountants of Sri Lanka (ICASL) initiated a scheme to set up a task force to look in to all aspects relating to the enforcement of the Sri Lanka Accounting Standards (SLAS). The task force recommended the setting up of an 'Accounting Standard Monitoring Unit', which resulted in the enactment of the *Sri Lanka Accounting and Auditing Standard Act No 15* of 1995. The act empowered the ICASL to adopt SLAS and Sri Lanka Auditing Standards (SLAuS). It also provided for setting up of an independent Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB) to carry out the oversight function. The Act required all the specified business enterprises (SBEs) to prepare their financial statements in accordance with the SLAS and have their accounts audited as per the SLAuS. The SBEs' are defined in terms of criteria based on turnover, share capital, net assets, number of employees and loans taken from the banking system and includes all the listed companies and other companies with large public interest. The SLAASMB now monitors the compliance of accounting standards and auditing standards as set out in the Act.

Corporate Governance Guidelines

In 1996, the ICASL set up a committee to make recommendations relating to the financial aspects of corporate governance in Sri Lanka, with the support of the Colombo Stock Exchange, Securities and Exchange Commission (SEC), Ceylon Chamber of Commerce and Institute of Directors of Sri Lanka. The ICASL published the first report on the *Code of Best Practice on Matters Relating to Financial Aspects of Corporate Governance* in 1997. The code was directed towards all listed companies, unit trusts, fund management companies, finance companies, banks, and insurance companies for voluntary compliance. The code provided a wider operational structure for carrying out corporate governance activities. The rules embedded in the code were primarily based on the Cadbury committee report (Watawala 2006).

In January 2000, the ICASL appointed a committee to revise, enlarge and expand the existing code to strengthen the corporate governance process in Sri Lanka. In 2002 the ICASL issued a code of best practice on audit committees. It was based on the *Combined Code* of UK and the *Smith Guidance*. To strengthen the corporate governance framework in Sri Lanka, a revision to the corporate governance code of 1997 was issued in 2003 by the ICASL in March 2003 (ICASL 2003). The compliance with the *Code of Best Practice on Corporate Governance 2003* was voluntary. Directors are required to include in the annual report a corporate governance report, setting out the manner and extent to which the company has complied with the established principles and practices of good corporate governance. In the event of non-compliance companies are required to set out the reasons for such non compliance. This is described as “if not why not approach”. Thereafter, the SEC felt there was a need to strengthen the independence of the auditors (Abhayawansa 2008). So in 2004, SEC issued a set of guidelines for listed companies relating to the audit and audit committees that were to be adopted on a voluntary basis with a view to making them mandatory. This took into consideration certain provisions of the *Sarbanes Oxley Act* of 2002 (Watawala 2006).

To further strengthen the corporate governance process in line with global developments, the ICASL and SEC, in consultation with CSE, formulated a new code of rules on corporate governance for listed companies in May 2006. The code addressed the important requirements for sound corporate governance and prescribed a balance with a minimal level of corporate governance, without imposing an excessive regulatory burden (Abhayawansa 2008). It was proposed that compliance with the code be mandatory for the companies listed on the CSE. The SEC issued a press release in January 2007, confirming the adoption of the 2006 code with minor amendments to the section on independent directors. The revised code *Standard on Corporate Governance for Listed Companies* was to be incorporated into the Listing Rules of the CSE, to be effective from 1st April 2007. In 2008 the *Code of Best Practice on Corporate Governance* was published jointly by the ICASL and SEC of Sri Lanka (ICASL & SEC of Sri Lanka 2008).

The implementation of the code was in two stages. In the first stage, companies were required to publish a table in the annual reports confirming their compliance to the Standards on Corporate Governance set out in the listing rules and if not, they needed to explain why they had not complied. All listed companies were required to comply with these rules in relation to the financial years commencing on or after the 1st April 2007. Compliance with *Standards on Corporate Governance* became mandatory for all listed companies for the financial years commencing on or after April 1st 2008 and the annual reports were required to contain a relevant affirmative statement. Failure to comply with listing rules would result in incurring penalties In the event of violation or non-compliance with listing rules, which reporting on corporate governance practices is one of the rules, securities of the entity will be transferred to the “Default Board” and may publicly reprimand such entity and/or suspend trading of securities of such entity for any period of time and/or delist the entity from the exchange (Colombo Stock Exchange 2011).

Table 3.2

Corporate Governance Reform Process in Sri Lanka

Year	Institutions	Code
December 1997	Initiated by ICASL, supported by: CSE, SEC Ceylon Chamber of Commerce Institute of Directors of Sri Lanka	The Code of Best Practice on Matters relating to Financial Aspects Corporate Governance
May 2002	ICASL	Code of Best Practice on Audit Committees
March 2003	ICASL	Code of Best Practice on Corporate Governance
May 2004	SEC & ICASL	Guidelines for Listed Companies in Respect of Audit and Audit Committees
May 2006	SEC, ICASL & CSE	Rules for Corporate Governance for Listed Companies
January 2007	SEC, ICASL & CSE	Standards on Corporate Governance for Listed Companies
2008	ICASL & SEC	Code of Best Practice on Corporate Governance

3.6 Corporate Governance Practices

As noted above, principles of good corporate governance in Sri Lanka were established through voluntary and mandatory mechanisms designed to introduce good governance practices for all listed companies. In 1997 the first voluntary code of best practice was introduced in Sri Lanka. This code covered the effectiveness of the Board, appointment of the chairman, non-executive directors, professional advice, director's training, directors responsibility for the presentation of financial statements, compliance reporting, internal control and committee structures for boards, including audit committee, and remuneration committees (Watawala 2006).

Code of Best Practice on Corporate Governance

The importance of separating the positions of chairman and CEO was identified in the 2003 and 2008 code (Section 1, Principle A.2), as it was undesirable to combine the positions from an internal control perspective. The codes (2003 and 2008) addressed the board balance in Section 1, Principle A.5. The board was required to include at least two non-executive directors or such number of non-executive directors equivalent to one third of the total number of directors, whichever is higher. In the event the Chairman and CEO is the same person, non-executive directors should comprise a majority of the board. Principle A.5.2 of the 2008 code states that where the constitution of the board of directors includes only two non-executive directors, both such non-executive directors shall be independent. In all other instances two or one third of non-executive directors appointed to the board of directors, whichever is higher, shall be independent. Principle A.5.5 of the 2008 code also states the criteria for defining independence and disclosures relating to directors. Further, the code addresses the appointment of board committees in relation to nomination (A.7.1), remuneration (B. 1.1), and audit (D.3.1). Principle D.4 of the 2003 code and D.5 of the 2008 code refer to corporate governance disclosures and the requirement by the directors to disclose the extent to which the companies adheres to established principles and practices of good governance. To enhance the effectiveness of the governance system, the voluntary codes were made mandatory for companies reporting on or after 1st April 2008 (ICASL 2003; ICASL & SEC of Sri Lanka 2008). Every company requiring to raise funds in the capital markets must be listed on the Colombo Stock Exchange and every company which makes an application for listing must comply with listing requirements of the Stock Exchange.

Codes on Audit Committees

The *Code of Best Practice on Audit Committees*, which was issued in 2002, provided guidelines on the role of audit committees, their composition, detail objectives relating to the financial reporting system, business risk management, internal controls, compliance with laws and company policies and the external audit function. The code also provided methodologies for achieving these objectives and evaluating the effectiveness of the audit committees. The new *Guidelines for Listed Companies in Respect of Audit and Audit Committees* was issued in 2004 and covered guidelines for audit of listed companies and guidelines for audit committees. The guidelines addressed external auditor related issues in respect of qualification and appointment of auditors, power of auditors, remuneration, rotation of partners and conflict of interest. Issues relating to conflict of interest are independence of auditors, disclosure requirements, restricted non-audit services and permissible non-audit services (Watawala 2006). However to date, these guidelines have not achieved mandatory status.

3.7 Corporate Reporting Practices

Financial reporting in Sri Lanka is primarily based on British legislation. The Institute of Chartered Accountants of Ceylon (prior to becoming the democratic socialist republic of Sri Lanka in 1972) was established by parliamentary act in 1959. In 1995, the Institute of Chartered Accountants of Sri Lanka was vested with the task of setting Sri Lankan accounting standards. The Sri Lankan accountancy profession, along with representatives from commercial and financial sectors and government officials, jointly developed the *Sri Lankan Accounting and Auditing Standard Act No. 5, 1995* (Athukorala & Reid 2002). Currently, Sri Lanka is in the process of adopting international financial reporting standards (IFRS). Sri Lankan Financial Reporting Standards will be fully compliant with IFRS by 2011. Section 8 of the Colombo Stock Exchange (CSE) stipulates that all publicly listed companies are required to report quarterly if listed on the main board, half yearly if listed on the second board and annual disclosures for all. Annual reports must contain an audited financial statement. The code of best practice on corporate governance requires the directors to include a report detailing the manner and extent to which the company has complied with the code in its annual report. Section 6 of CSE rules states that it shall be mandatory for all listed companies to publish a table in the annual report that complies with the corporate governance rules, and if not explanation for the reason of not complying with identified rules must be provided.

CSR reports are evident in corporate websites as well as in the corporate reports of most top listed companies in Sri Lanka. A large number of listed companies engage in CSR activities of various forms. Many companies consider CSR as an important component of business. Therefore inclusion of a social responsibility statement in their annual reports is common among a large number of companies in Sri Lanka (Ariyabandu & Hulangamuwa 2002).

3.8 Corporate Social Responsibility in Sri Lanka

Sri Lanka has a long history of corporate philanthropy. Charitable activities performed by the business communities to support various needs of the society is not a new concept in Sri Lanka (Ariyabandu & Hulangamuwa 2002). Even though the responsibility for developing the disadvantaged sector of the community lies with the government, this role has been taken over by private institutions in Sri Lanka, due to weak and corrupt government structures and the diversion of public funds to fight the ethnic war.

Firms surveyed by International Alert (2005) stated that "concentrating on improving living conditions of the local community would facilitate expansion of company activities". Ariyabandu and Hulangamuwa (2002) categorize the main forms of CSR activities observed in Sri Lanka as philanthropic and charitable activities, environmental conservation, public awareness and corporate sponsorships (Ariyabandu & Hulangamuwa 2002). The majority of organisations in Sri Lanka are engaged in CSR activities relating to education, health, unemployment, entrepreneur development, employee welfare and provision of infrastructure facilities. There are others who concentrate on environmental issues such as reducing the pollution associated with poverty, reduction of greenhouse gas emissions and cleaning beaches. In Sri Lanka, the activities that relate to rebuilding the communities are supporting educational needs, health and environmental issues, housing, providing entrepreneurship programmes and vocational training to youths to reduce unemployment. Improvement of local living conditions by providing water and sanitation are also included.

Further, the survey conducted by International Alert (2005), states that most respondents from the business community felt that they have a strong role to play in meeting society's needs. According to the survey, the reasons for engaging in CSR activities in Sri Lanka were reported as image building, long-term benefits to current investment and a transparent relationship with society in dealing with controversial products. Large local companies practice CSR in an organized basis. In 2007, 75% of the top fifty listed companies in Sri Lanka disclosed their CSR initiatives in their annual reports. Fernando (2007) states that according to a survey conducted by International Alert in 2004, 73.2% companies had a CSR policy, and 17% of those, had a formal written policy with 84.1% of the companies engaged in CSR because they genuinely contributed to the betterment of society. Transnational corporations operating in Sri Lanka are guided by the policies of the parent company. However, they carry out their CSR policies to suit the local context. According to a study conducted by International Alert (2005) in Sri Lanka, respondents mentioned social responsibility extended beyond shareholders to those affected by the operation of the company. Some thought CSR contributed to the well being of society, whereas others stated that it was a benefit to the business itself.

3.9 Corporate Governance, Capital Markets and Firm Performance in Sri Lanka

Development of the capital markets resulted in the introduction of a code of best practice in corporate governance in Sri Lanka, but the application of the code was not compulsory for the period under review for this research. Companies had a degree of autonomy in selecting an appropriate mix of internal mechanisms, such as board structures consisting of duality or separate leadership, board composition and board committees. In Sri Lanka, the factors that affect firm performance and ultimately market performance are rising interest rates, inflation, political sentiment and security conditions (Securities and Exchange Commission of Sri Lanka 2007). Even though firms faced the volatility in the environment due to the above factors, the management of the firms has resulted in healthy balance sheets (Bloomberg 2007).

3.10 Characteristics of the Top 50 Listed Firms in Sri Lanka

Companies from 14 sectors of the economy were ranked among the top 50 listed companies in Sri Lanka in order of turnover for 2007, which is represented in Table 3.3 and Figure 3.3. The largest sector was banking, finance and insurance. The second largest was diversified holdings. The third largest was beverage, food and tobacco and two telecommunication giants were ranked fourth.

Table 3.3

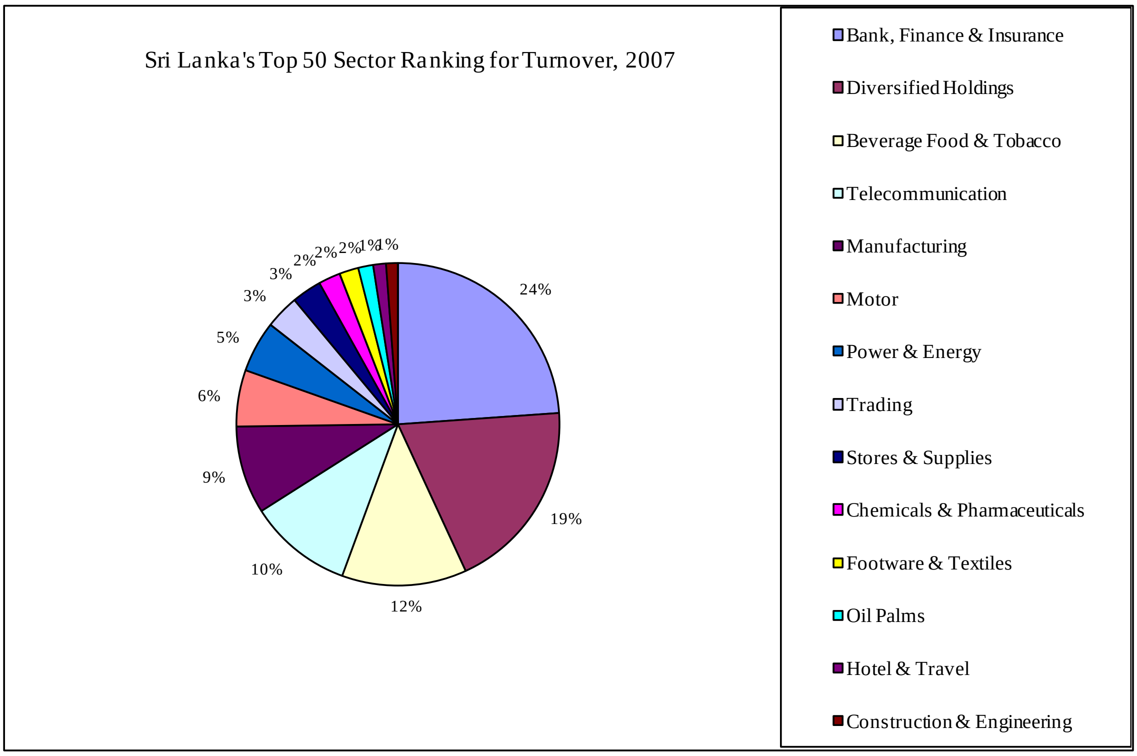
Sector Ranking of the Top 50 Listed Companies

Rank	Sector	Turnover (Rs. M)	Total Assets (Rs.m)	Shareholders Funds (Rs. m)
1	Bank, Finance & Insurance	152,582	999,239	87,601
2	Diversified Holdings	123,017	184,842	80,931
3	Beverage Food & Tobacco	79,780	99,749	22,407
4	Telecommunication	66,370	127,468	62,849
5	Manufacturing	56,240	44,962	16,795
6	Motor	36,098	21,363	8,020
7	Power & Energy	32,796	21,128	7,655
8	Trading	21,628	20,928	8,616
9	Stores & Supplies	19,110	8,139	1,713
10	Chemicals & Pharmaceuticals	13,954	10,257	3,937
11	Footwear & Textiles	12,239	8,006	3,087
12	Oil Palms	9,621	30,330	7,315
13	Hotel & Travel	8,206	24,144	12,760
14	Construction & Engineering	7,485	6,021	2,345
	Total	639,126	1,606,576	326,031

Source: The LMD 50 2006/2007

Figure 3.3

Sri Lanka's Top 50 Ranking in 2007 for Turnover

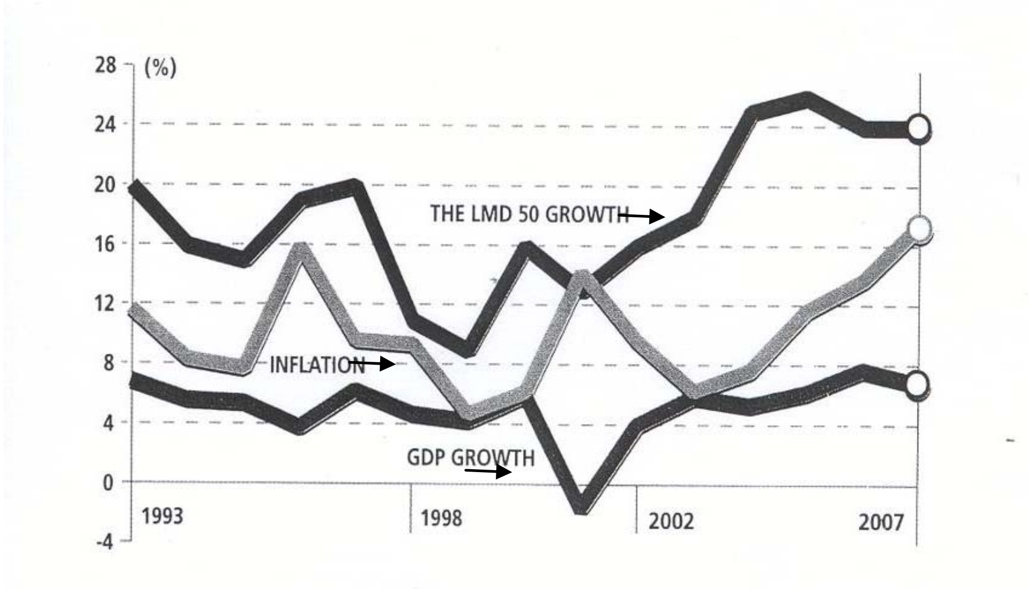


Source: The LMD 50 2006/2007

In 2007, the LMD 50 companies enjoyed a growth rate in total turnover of 24 percent to Rs.639,126 billion, ranging from Rs.3,982 million to Rs.40,691 million with banking, finance and insurance at the top of the list. Total assets were valued at Rs.1,606,576 billion and shareholders funds were Rs.326,031 billion for 2007. Table 3.3 represents the turnover, total assets and shareholders funds for each sector. The companies in the LMD 50 had a market capitalisation of Rs.698150 billion with share prices ranging from Rs.14.25 to Rs.4,270 (The LMD 50 2006/2007). The engine of growth was blocked by terrorism and the ongoing war in the north and east, which are among the chief impediments to growth in corporate bottom lines in Sri Lanka. However growth in LMD 50 turnover which was three times higher than GDP growth in the country for 2007, is presented in Figure 3.4.

Figure 3.4

Macro Trends: The LMD 50 versus. GDP and Inflation



Source: The LMD 50 – 2007/2008

3.11 Conclusion

This chapter examined the overall context of the study, including the historical background of corporate governance in Sri Lanka leading to current developments in corporate governance. The effect of the economic and political environment was discussed in length, as it affects the firm performance in Sri Lanka. The development of capital markets has encouraged the government to influence regulatory reforms in corporate law and to promote effective corporate governance practices that attract external investment. Accountability is an important aspect of corporate governance. Therefore corporate reporting practices in Sri Lanka in relation to financial performance and social performance indicated by the corporate social responsibility of companies were discussed, because corporate reporting practices can have an impact on firm performance. Finally, an overview of the characteristics of the top 50 listed companies was discussed, as the sample for the study was taken from the LMD top 50 listed companies for 2003 and 2007. The next chapter will focus on the theoretical perspective of the study.

Chapter 4

Conceptual Framework and Hypotheses Development

4.1 Introduction

In Sri Lanka corporate governance principles are defined by the Code of Best Practices on corporate governance issued jointly by the Securities and Exchange Commission of Sri Lanka and The Institute of Chartered Accountants of Sri Lanka (refer to chapter 3).
A review of the limitations in previous research suggests that the relationships between corporate governance practices such as separate leadership structure, board composition, board committees, corporate reporting and their effect on firm performance has not been sufficiently studied in developed or developing countries experiencing unstable economic and political environments. This is the case in Sri Lanka.

A conceptual framework developed in this chapter provides a framework to understand the affects of the above variables on firm performance, and identifies the hypotheses regarding the relationship of corporate governance variables to firm performance in Sri Lanka. Section 4.2 presents a theoretical perspective on corporate governance and firm performance. This is followed by the development of the theoretical framework in section 4.3. Development of a conceptual framework, discussed in section 4.4, is followed by the corporate governance model for the study in section 4.5. Section 4.6 provides a discussion of the hypotheses development for the study and section 4.7 discusses the firm performance in relation to the study. Section 4.8 consists of the conclusion of the chapter.

4.2 Theoretical Perspective on Corporate Governance and Firm Performance

Corporate governance structure and the, role and impact of the board, studied by various scholars from a variety of theoretical perspectives, has resulted in a number of competing theories (Kiel & Nicholson 2003). Scholars from disciplines of law (Richard & Stearn 1999), economics (Jensen & Meckling 1976), finance (Fama 1980), sociology

(Useem 1984), strategic management (Boyd 1995) and organization theory (Johnson 1997), have contributed to governance research (Kiel & Nicholson 2003). Numerous governance theories have emerged from these disciplines including agency theory, stewardship theory, resource dependency theory, stakeholder theory, social contract theory and legitimacy theory. The main theories that apply to this study are agency theory, stewardship theory and stakeholder theory.

Agency Theory

Among various theories discussed in the literature, agency theory provides a rational argument for the introduction of corporate governance mechanisms. Agency theory is concerned with ensuring that managers act in the interest of the shareholders. It is based on the premise of inherent conflict of interest between the owners and management (Fama & Jensen 1983). Problems arise as a result of managers' incentives to pursue their own interests at the expense of shareholders (Agrawal & Knoeber 1996; Fama & Jensen 1983; Jensen & Meckling 1976).

According to agency theory adequate monitoring or control mechanisms are needed to protect the shareholders and management from conflicts of interest (Fama & Jensen 1983). The argument is that managers may be involved in empire building or other pursuits that may not improve the value of the firm. Initiatives such as the appointment of non-executive directors to a board, to control management, are designed to address this issue. A higher proportion of non-executive directors on the board is viewed to have a positive effect on firm performance (Fama & Jensen 1983; Jensen & Meckling 1976; Shleifer & Vishny 1997). Furthermore, Keil and Nicholson (2003) affirm that agency theory leads to normative recommendations that a board should be comprised of a majority of outside independent directors and have separation of the position of chairman and CEO to increase shareholder value.

Stewardship Theory

Stewardship theory presents a contrasting view to agency theory. This theory asserts that there will not be any major agency costs, since managers are naturally trustworthy (Donaldson 1990; Donaldson & Preston 1995). According to the perspective of the stewardship theory, managers are inherently trustworthy and faithful stewards of the corporate resources entrusted to them (Donaldson 1990; Donaldson & Davis 1991, 1994). Managers are good stewards of the organization and it is in their own interest to work to maximize corporate profits and shareholder returns (Donaldson & Davis 1994). Therefore proponents of stewardship theory argue that firm performance is linked to a majority of inside directors and combined leadership structure (Donaldson & Davis 1991; Kesner 1987).

Stewardship theory sees a strong relationship between managers striving to successfully achieve the objectives of the firm, and the resulting satisfaction accorded to investors/owners, as well as other participants in the enterprise (Clarke 2004). A virtuous circle is evident in stewardship theory, where stewards protect and maximize shareholder wealth through firm performance, which results in maximizing the stewards' utility. Therefore, by improved firm performance, the organization satisfies most groups that have an interest in the organization. Thus, stewardship theory supports the need to combine the role of the chairman and CEO and favour boards consisting of specialist executive directors rather than majority non-executive directors.

Stakeholder Theory

Stakeholder theory explains the accountability of the board to more than the shareholders, and includes those who can affect or are affected by the achievement of the firm's objectives (Freeman 1984). If the achievement of a firm's objectives can be affected by stakeholders, then a firm's decisions, and hence its performance, can be affected by the stakeholder activities, and in turn the firm's decisions may affect the well-being of its stakeholders (Berman et al. 1999). If a corporate managers' jobs are to maximize the total wealth of the organization, they must take into account the effects of their decisions on all the stakeholders (Clarke 2004).

An important feature of stakeholder theory is that a firm must be profitable and viable, because the prospective stakeholders will be reluctant to take a stake in companies that are likely to lead to market place failures (Jones & Wicks 1999). An economically successful firm is one in which senior managers adopt corporate governance strategies and policies that facilitate the maintenance of an appropriate balance between the interests of the different stakeholders (Ogden & Watson 1999). It is unlikely that the managers can maximize the value of a firm to its owners by completely ignoring the interest of other stakeholders. Therefore according to the stakeholder theory, managers must consider the impact of their decisions on a broad spectrum of stakeholders and evaluate their decisions based on the impact on the market value of their firm (Bird, Ron. et al. 2007). Stakeholder theory also supports the practice of corporate social responsibility activities. However this raises issues about the need for accountability for activities not reflected in financial reports. Therefore, many companies prepare a separate CSR report to inform society of their accountability (Deegan 2004).

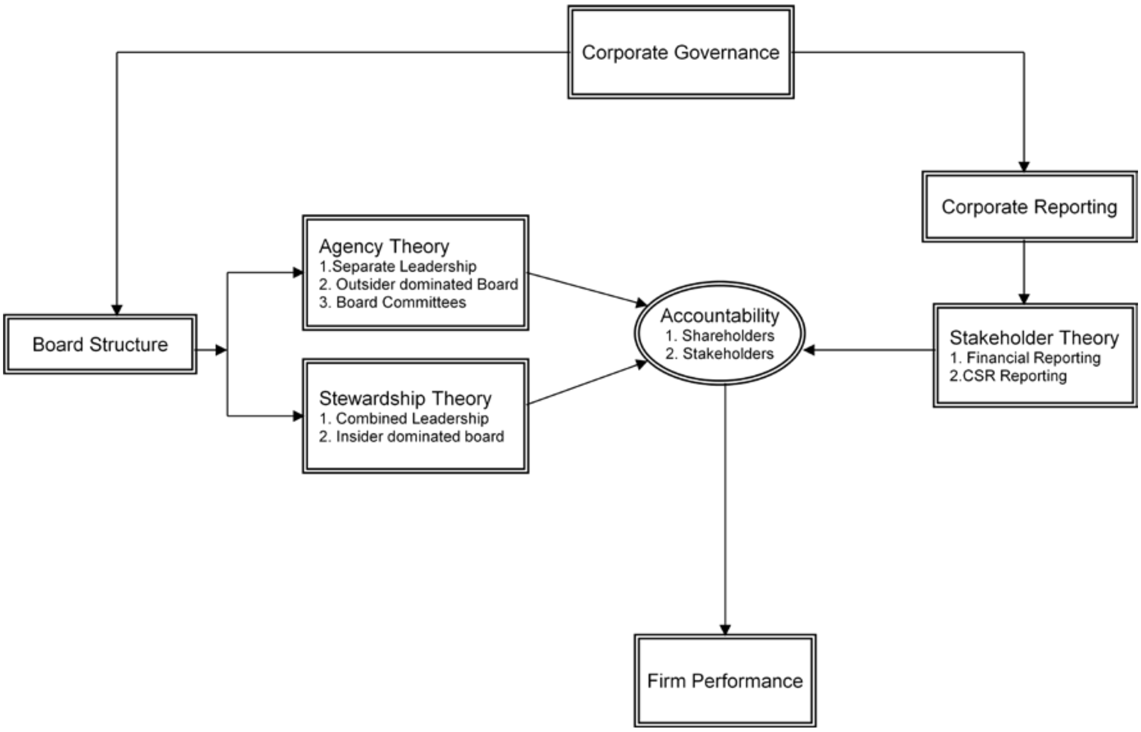
4.3 A Theoretical Framework

A framework drawn from these three theories is shown in figure 4.1. It suggests that in this study board structure is represented by two sets of variables. Those supported by agency theory are separate leadership, a board dominated by ‘outside, or independent directors, and the appointment of board committees. In contrast, board structure supported by stewardship theory could include combined leadership and an ‘inside’ or executive dominated board.

The review of stakeholder theory and research suggests that different forms of accountability are due to shareholders and the wider group of other stakeholders. In this study accountability to shareholders is assumed to be via financial reporting, while corporate social responsibility reporting provides a means of accountability to other stakeholders.

Figure 4.1

Theoretical Framework: Corporate Governance and Firm performance



The theories reviewed in the above theoretical framework focus on how corporate governance affects performance. Agency theory focuses on conflicting interests between principals and agents, and maximizing shareholder returns. Therefore, agency theory considers separate leadership structure, outside directors and board committees as optimal monitoring devices that will maximize the value of firms. Stewardship theory views managers as stewards of the corporation and considers that a combined leadership structure and insider dominated boards are likely to maximize shareholder wealth. On the other hand, stakeholder theory holds that the firm has a responsibility to serve all the stakeholders who are affected by the activities of the firm, which would result in reporting to a broader stakeholder group beyond financial reporting. Stakeholder theory suggests that CSR practices of the firm will increase market value in the short term and profitability in the long term.

4.4 Development of a Conceptual Framework for this study

The conceptual framework (Figure 4.2) illustrates the link between the above theoretical framework and operationalisation of the corporate governance variables and firm performance that are investigated in this study. Evidence from empirical research suggests that there are several variables that influence the relationship between corporate governance and firm performance (refer to Chapter 2). Internal corporate governance mechanisms include board leadership structure, board composition, role of the audit, remuneration and nomination committees. Some of the variables identified in the corporate governance literature to measure firm performance are Tobin's Q, Return on assets (ROA), Return on equity (ROE).

This study examines the relationship between corporate governance and firm performance. The conceptual framework comprises of internal corporate governance variables, board structure and corporate reporting practices, which are considered important in affecting firm performance. The board structure referred to in this study includes separate leadership, combined leadership, outsider and insider dominated boards and board committees. Corporate reporting includes financial reporting and CSR reporting. Firm performance variables used in this study are accounting measures of ROE, ROA and market-based measure of Tobin's Q.

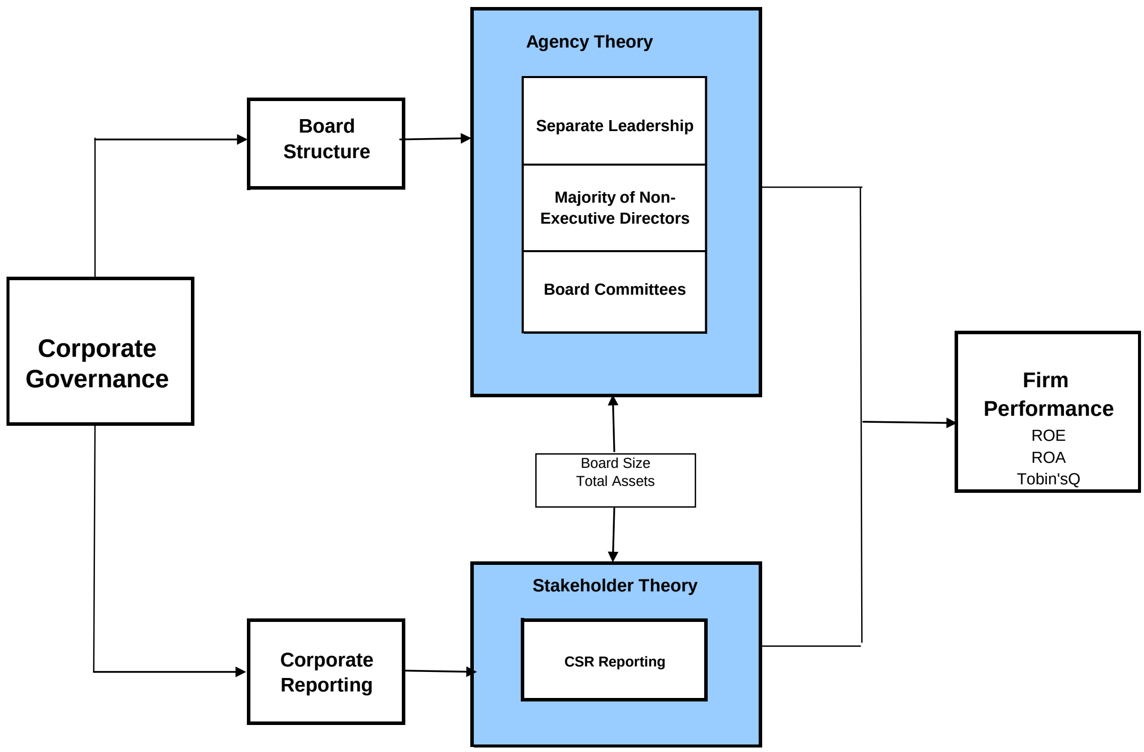
The variables, considered important in affecting firm performance in the conceptual framework, comprise of separate leadership structure, a majority of non-executive directors and the existence of board committees, which are supported by agency theory. CSR reporting in this framework is supported by stakeholder theory. The variables that represent firm performance are Tobin's Q, ROA and ROE.

Firm performance in this study is measured by market value of firm. Tobin's Q is a proxy for market value measured by share prices to book value. Share prices are affected by accounting information and voluntary disclosures, which is reflected in the value of the shares. Accounting information includes corporate governance practices and voluntary disclosures include CSR practices of the firms in this study. Better governance increases efficiency and output to the firm, which means investors' funds are used more productively (Love 2010). Therefore better governed firms are valued more by investors resulting in movement of share prices, which indicates that this information is incorporated in the security prices through the activities of the investors resulting in firm performance (Deegan 2004).

The scope of this study is restricted to determining the relationship between internal governance mechanisms and firm performance in an unstable political and economic environment.

Figure 4.2

Conceptual Framework: Corporate Governance Practices and Firm Performance



4.5 Hypotheses Development

The theoretical framework presented above will be used to develop the testable hypothesis for the study. The basis of the hypothesis is that the introduction of corporate governance best practices namely the board leadership structure, board composition, board committees and corporate reporting practices, will be reflected in firm performance. However, the stock markets in Sri Lanka are resilient to the shocks that affect the external environment such as the political, economic and natural disasters. Therefore, the hypothesis presented in this study will be tested to investigate the effect of corporate governance practices on firm performance in an unstable political and economic environment.

Hypotheses

The hypotheses of this study are based on the argument that good governance practices, namely board structure and corporate reporting practices, affect firm performance in Sri Lanka. The ability of the capital markets to attract investor confidence depends on good corporate governance. The main function of the board is to monitor the top managers for their stewardship and their accountability to shareholders and other stakeholders who are affected by the activities of the firm. The monitoring mechanism of the board leadership structure (H1a), board composition (H1b) and board committee (H1c) is represented to investigate the boards' accountability to shareholders through firm performance. Corporate social responsible reporting (H1d) indicates the board's accountability to other stakeholders and its effect on firm performance.

Board leadership structure and firm performance

Based on the literature in Chapter 2, the leadership structure of the firm will have an important impact on performance, because board leadership structure is a device that is implemented to monitor the CEO (Abdullah 2004; Coles, McWilliams & Sen 2007; Dalton et al. 1998; Donaldson & Davis 1991). As such, leadership structure is considered important in affecting firm performance in this study.

The importance of leadership structure was addressed by the Cadbury Committee (1992) and Hampel Committee (1998). They recommended the roles of chairman and CEO should be separated. A combined leadership structure was criticised as an inappropriate way to design the most powerful relationships in a firm. To be effective, it is important to separate the positions of CEO and chairman (Jensen 1993). According to this view, concentrated power provides an opportunity for CEOs to make decisions to benefit themselves at the expense of the shareholders. Combined leadership structure is also linked with signs of ineffective governance such as hostile takeovers (Morck, Shleifer & Vishney 1989) and the adoption of poison pills (Mallette & Fowler 1992). It is the responsibility of the board to monitor the functions of the top management. But when the chairman is also the CEO, his/her ability to monitor and oversee the management is reduced, resulting in lack of independence and conflict of interest (Daynton 1984; Dobrzynski 1991; Fizel & Louie 1990; Lorsch & MacIver 1989; Millstein 1992). Therefore, Cadbury (1992) suggests that if the chairman is also the CEO, it is important to have a strong independent element on the board. Furthermore, Coles, McWilliams et al. (2007) state that an explanation for many firms not separating the position of chairman and CEO is that the impact of the leadership structure is closely related to the composition of board of the directors.

Given the importance of the chairman's role in securing good governance, Cadbury (1992) suggests that in principle the role of the chairman and CEO should be separated. In Sri Lanka the *Code of Best Practice on Matters Relating to Financial Aspects of Corporate Governance* issued in 1997 and *Code of Best Practice on Corporate Governance* issued in March 2003, both recommended the separation of the position of CEO and Chairman. These recommendations were made mandatory for companies reporting on or after 1st April 2008 for listed companies in Sri Lanka. They state that if the two roles are combined, it represents a considerable concentration of power. Therefore, there should be a clear division of responsibilities, which will ensure balance of power and authority, so that one person will not have unfettered powers of decision. When the monitoring role and the implementation role are combined, the monitoring role and the independence of the board will be severely impaired affecting management's pursuit of value maximizing activities for the firm (Abdullah 2004).

As stated in the theoretical framework, both agency theory and stewardship theory apply to board leadership structure and its relationship to firm performance. Board reform advocates promote separation of the position of CEO and chairman, which is largely grounded on the agency theory, because of their concern of the potential for management dominated boards. Combined leadership structure promotes CEO entrenchment and can lead to opportunistic and inefficient behaviour that reduces shareholder wealth (Jensen & Meckling 1976). Similarly, Finkelstein and D'Aveni (1994) state that, advocates of agency theory argue that combined structure promotes CEO entrenchment by reducing board monitoring effectiveness. A single person serving as the chairman and CEO will acquire extensive power and control which will weaken the decision control by the board (Morck, Shleifer & Vishney 1989). When the boards control reduces, it will allow the CEO to pursue goals that are substantially different from shareholder goals (Mallette & Fowler 1992). Again agency problems and the board's failure to control have been linked to negative outcomes, such as: payment of greenmail (Kosnik 1987), awarding golden parachutes (Singh & Harianto 1989), adoption of poison pills (Mallette & Fowler 1992), and higher levels of executive m compensation (Boyd 1994). As a result, agency theory propose that combining the positions of CEO and chairman, weakens board control and affects board performance negatively (Boyd 1995). Therefore, as suggested by the agency model a negative relationship exists between combined leadership structure and firm performance.

Advocates of the stewardship theory suggest that the combined leadership structure provides a unified leadership structure and removes any internal and external ambiguity regarding the responsibility for firm processes and outcomes (Donaldson 1990; Finkelstein & D'Aveni 1994). Therefore, as suggested by stewardship theory, as a result of unified leadership, the combined structure will facilitate superior firm performance. A study conducted by Donaldson and Davis (1991) found results consistent with this view, that firms relying on combined leadership structure achieved higher shareholder returns, as measured by return on equity, compared to the firms with separate leadership structure. Stewardship theory addresses some of the limitations of agency theory as applied to combined leadership. Boyd (1995) addresses these limitations and states that combined leadership is considered as providing clear direction of a single leader and faster response to external events. Similarly, as with other insider directors, an individual holding both the CEO and chairman position is expected to have greater knowledge about the firm and industry, and will be more committed to the organization than an external chairman. He also states that proponents of combined leadership structure consider the position of the chairman as being relatively less powerful and more ceremonial and symbolic than the position of CEO.

There is also empirical evidence which reports that the leadership structure has no impact on firm performance (Daily & Dalton 1992, 1993a; Rechner & Dalton 1989). Examination of shareholder returns over a period of five years by Rechner and Dalton (1989), found no significant distinction between separate and combined leadership structure and performance. However, in a later study they found that a separate structure outperformed a combined structure when examining the accounting based measures of return on equity (ROE), return on investment (ROI) and profit margin (Rechner & Dalton 1991). In contrast to the findings of Rechner and Dalton, there is very little evidence to support performance distinction between separate and combined firms when using market value added and economic value added as performance measures (Balinga, Moyer & Rao 1996).

But the separation of the two positions is also required because of the need to attract external finance (Suryanarayana 2005). It makes an important contribution to increasing accountability and ensures the shareholders interests are given due weight (Baxt, Ramsay & Stapledon 2002). As a result, separate leadership can impact the market value of a firm.

Examination of empirical research has provided important insights into the relationship between leadership structure and performance (Abdullah 2004; Rechner & Dalton 1989; Rechner & Dalton 1991). Therefore as suggested by the agency theory, the conceptual framework considers the importance of separating the roles of chairman and CEO in affecting firm performance. To test the above argument in relation to the Sri Lankan context the following hypotheses is suggested.

***$H0_a$*: Separate leadership structure is not associated with firm performance.**
H1a: Separate leadership structure is positively associated with firm performance.

Board composition and firm performance

The composition of the board in this research refers to the proportion of inside and outside directors serving on the board. The distinction between the roles of inside and outside directors is important, because the latter bring in specific advantages and disadvantages. Access to inside information by the inside directors is as important as the expertise and objectivity of the outside directors in evaluating managers decisions (Li 1994).

Board composition is an important component of corporate governance that affects firm performance in Sri Lanka. Best practice recommendations on corporate governance require boards to be composed of a majority of non-executive directors (ASX Corporate

Governance Council 2003b; Cadbury 1992; Hampel 1998; OECD 1999). These recommendations were also incorporated in the code of best practice on corporate governance in Sri Lanka, because investors consider boards composed of non-executive directors as an important determinant of firm performance.

Both agency theory and stewardship theory apply to board composition. Separation of ownership and management is a characteristic of modern corporations that is built on agency theory, because managers tend to gain control in the firm by pursuing actions that benefit themselves and not the owners (Jensen & Meckling 1976). For this reason, the primary function of the board is to protect the shareholders (Fama & Jensen 1983). According to agency theory, boards composed of a majority of outside directors will serve this primary function.

Alternatively, stewardship theory argues managers are inherently trustworthy, are not prone to misappropriation of corporate resources (Donaldson 1990; Donaldson & Davis 1991) and are good stewards of the organization who work diligently to attain a higher level of corporate profits and shareholder returns (Donaldson & Preston 1995). Accordingly, proponents of stewardship theory argue that superior performance of the firm is linked to a majority of insider directors. They work to maximize shareholders wealth, and their knowledge of the business is better than the outside directors, resulting in superior decisions (Donaldson 1990; Donaldson & Davis 1991). As a result, there will be no agency costs, since senior executive are naturally trustworthy (Donaldson 1990; Donaldson & Preston 1995) and will not disadvantage shareholders for the fear of damaging their reputation (Donaldson & Davis 1994). Therefore stewardship theory argues that the board should be comprises of a significant proportion of executive directors to ensure effective and efficient decision-making.

In contrast, empirical evidence in support of the agency theory, suggests that, outside directors are valued for their ability to provide advice, solidify business and personal relationships, their ability to signal when the company is doing well, and for their title and prestige (Mace 1971). They also play an important role as shareholder advocates when they control the boards in tender offers for bidders (Byrd & Hickman 1992), in hostile takeover threats (Gibbs 1993) and in helping to reduce the likelihood of financial statement frauds (Beasley 1996).

Brickley (1994) and Byrd and Hickman (1992) also reported that share price reactions tend to be positive (or less negative) when the boards are dominated by outside directors. Studies which conclude that a majority of outside directors results in better monitoring, have reported reduced fraud (Beasley 1996), and management's compensation is more likely linked to enhancing shareholder wealth (Ellingson 1997). Outside directors bring to the board reputational capital and expertise, which play an important role providing guidance to the management in exercising firms' growth options. Strong monitoring, expertise and business contacts of the external directors increase the probability that the firm's growth options are exercised at an optimal time to maximize shareholder value (Matolcsy, Stokes & Wright 2004). The appointment of a higher proportion of independent directors enhances the value of companies by providing substantial growth options (Zoltan Matolcsy 2004). However, Weishbach (1988) finds a majority of outside directors has also been associated with a negative relationship between CEO turnover and performance.

Alternatively inside directors are also considered to have a positive effect on the firm. They possess valuable information specifically important to the firm's activities. They act as arbiters in disagreements among internal managers, reduce the firm's risk by monitoring manager selection, exercise valuable growth options, hire the CEOs and monitor their performance. They also add value to a firm by engaging in activities that reduce the risk investors face, thereby reducing the firms cost of capital and increasing market confidence because of their reputation. However, it has been suggested where the board is dominated by insiders, monitoring of the CEO by the board would be relatively weak, because the CEO can influence the career of inside directors (Matolcsy, Stokes & Wright 2004).

A number of studies in the past, which aimed at establishing the effect of outside directors on the success or failure of firms, have examined the board composition and its impact on firm performance (Barnhart, Marr & Rosenstein 1994; Beasley 1996; Byrd & Hickman 1992; Daily & Dalton 1992; Fosberg 1989; Hermalin & Weisbach 1991; Schellenger, Wood & Tashakori 1989). However, empirical evidence on outside independent directors and firm performance is mixed, as there are some studies which found a majority of outside independent directors improved performance (Barnhart, Marr & Rosenstein 1994; Daily & Dalton 1992; Schellenger, Wood & Tashakori 1989), while there are other studies which did not find a relationship between a majority of outside independent directors and improved firm performance (Fosberg 1989; Hermalin & Weisbach 1991; Molz 1988). These mixed results may indicate that there is no clear benefit of independent directors in firm performance (Petra 2005).

However, as stated above in corporate governance practices, effective monitoring requires a higher representation of non-executive directors, who are independent of executive directors. Moreover, it has been suggested that boards dominated by non-executive directors may alleviate the agency problem of the opportunistic behavior of managers, through their monitoring and controlling role (Berle & Means 1932; Jensen & Meckling 1976). Boards dominated by non-executive directors can also influence the quality of directors deliberations and decisions, and provide strategic direction resulting in improved performance (Pearce & Zahra 1992).

The relationship between board composition and firm performance has been reported in prior research. According to the arguments put forward by agency theory, non-executive directors are an important component of the board structure that affects firm performance. The conceptual framework considers the importance of non-executive directors in increasing firm performance in the context of Sri Lanka. To test the above arguments the following hypotheses are suggested.

$H0_b$: A majority of non-executive directors on the board is not associated with firm performance.
H1b: A majority of non-executive directors on the board is positively associated with firm performance.

Board Committees and firm performance
Board committees are an important component of the board structure of companies in Sri Lanka, which affect firm performance. The existence of board committees is considered by investors in their investment decisions. A focus in setting up sub-committees was emphasized by the Cadbury Committee (1992) for specific areas of governance that have been identified as problematic. The areas considered important were the quality of financial reporting, director remuneration and appointment of

directors (Spira & Bender 2004). Therefore, the Cadbury Committee (1992) recommended establishing oversight committees for remuneration of executive directors, the auditing of financial statements and appointment of directors, which was supported by agency theory. They considered board committees were an additional control mechanism that increased accountability and ensured the interests of the shareholders were being safeguarded. ASX principles (2003) recommend establishing audit, remuneration and nomination committees for all listed companies. The *Code of Best Practice on Corporate Governance* (2003) also has recommended similar practice to listed companies in Sri Lanka.

Cadbury (1992) stated that these committees should be staffed by non-executive directors, because of their independent view on important decisions. Therefore, board committees consisting of audit, remuneration and nomination committees, must be composed of outside directors, because outside directors are believed to ensure decisions made by the executive directors are in the best interest of the shareholders (Weir & Laing, David 2001). OECD principles also state that such committees should be dominated by independent directors. Unless the committee is dominated by independent non-executive directors, it could be only a window dressing (Keong 2002).

The importance of board committees has heightened as a result of corporate collapses around the world. Board committees are appointed to function as independent monitors. The principal function of an audit committee is to meet regularly with the external and internal auditors to review the financial statements, audit process and internal controls of the firm. This helps to alleviate agency problems by the timely release of unbiased accounting information by managers to shareholders and others who rely on such information, thus reducing information asymmetry between insiders and outsiders. A remuneration committee's function is to determine and review the nature and amount of all remuneration to senior officers of the firm. Remuneration committees help to alleviate agency problems by designing and implementing incentives and bonus schemes that will align the goals between senior managers and shareholders (Klein 1998). The oversight function of the board committees is supported by agency theory, because independent monitoring alleviates agency problems (Klein 1998; Rezaee 2009).

The establishment of board committees is expected to have a positive influence on the motivation of the directors and provide confidence in the financial reports of the firm. Favourable capital market reactions to the establishment of audit committees were noted by Wild (1994). Laing and Weir (1999) also reported that the companies, which introduced board committees to the board structure, performed better than those without them, and showed a significant improvement in firm performance by firms which have introduced audit and remuneration committees. In contrast, there is also evidence to support the view that board subcommittees had no effect on firm performance (Theodorou 1998; Weir, Laing & McKnight 2002).

Given the recommendation in the codes of practice, monitoring by board sub committees is expected to have a positive influence on firm performance. As suggested in agency theory, the monitoring function of board sub-committees is an important mechanism of corporate governance, considered in the conceptual framework and in improving firm performance in the context of Sri Lanka,. To test the above argument the following hypotheses are suggested.

$H0_c$: Boards committee structures composed of audit, remuneration and/or nomination committees are not associated with firm performance.
H1c: Boards committee structures composed of audit, remuneration and/or nomination committees are positively associated with firm performance.

Corporate Social Responsibility and Firm Performance

Corporate social responsibility reporting (CSR) is considered an important aspect of corporate reporting practices in influencing the value of the firm in Sri Lanka, which is explained in the stakeholder theory. Stakeholder theory considers shareholders as one among other stakeholders affected by the performance of the firm. Tenet among the theory is maximization of human welfare (Bhasa 2004). The needs of the shareholders are met by satisfying the needs of the other stakeholders (Jamali 2008). Therefore it is believed that the value of a firm is affected by the CSR activity of the firm and is dependent on sustainability rather than short-term profitability.

There has been much debate, about whether directors' responsibility extends beyond maximizing shareholder wealth. It is the directors who are called upon to balance the interest of stakeholders, when interests of various stakeholders conflict (Baxt, Ramsay & Stapledon 2002, 166). Different views persist representing these different theoretical perspectives.

Neo-classical economists view of the role of professional management is to maximize long-term market values of firm, thereby increasing the wealth of shareholders or the owners (Bird, Ron et al. 2007). Similarly, Friedman (1970) argues that management of public companies is by the agents for shareholders, and their responsibility is to act in the best interest of the shareholders, which suggests that they have no right to expropriate shareholders wealth for the benefit of other parties. As a consequence, it is the responsibility of the government to consider the impact of companies on the other stakeholders (e.g. through taxation, regulations). However, in contrast to the above view, stakeholder theory suggests that the decision of management should extend to the interest of the wider spectrum of stakeholders (Freeman 1984).

The relationship between CSR and economic performance can also be explained by modern stakeholder theory, which explains that the value of a firm is related to the cost of both explicit claims and implicit claims (Freeman 1984; McGuire, Sundgren & Schneeweis 1988). If these implicit contracts are not honored by the firm, then the parties to the contract may attempt to transform them into explicit agreements and this may be costly (McGuire, Sundgren & Schneeweis 1988). Firms with a high CSR image may be faced with fewer and lower explicit claims.

As cited by McGuire (1988), arguments for companies to be perceived as high in social responsibility, may encounter fewer labour problems or customers may include that they be more favourably disposed to their products. Firms' reputation and relationship with bankers, investors and government officials also improves with CSR activities. There are studies that confirm firms' CSR behavior as a factor that influences banks and other institutional investors' investment decisions (Graves & Waddock 1994; Pava & Krausz 1996; Rosen, Sandler & Shani 1991). Therefore corporate social responsibility of a firm may improve its access to sources of capital.

Meta-analysis conducted by Frooman (1997) concludes that companies engaged in socially irresponsible activities and illicit behavior suffered in their market valuation. This was confirmed by Johnson (2003), who found that illegal or irresponsible behaviour was punished by investors, but did not find evidence to conclude the companies that go beyond legal and community standards were rewarded by the market by way of higher market valuation.

On the contrary, Balabanis et al. (1998) states that those who argue for the existence of a negative relationship between social responsibility and economic performance explain that high investment in social responsible activities results in additional costs. These additional costs resulting from social responsible activity may put the company at an economic disadvantage compared to less socially responsible companies (McGuire, Sundgren & Schneeweis 1988).

According to Velde et al. (2005), socially responsible companies put the interests of the shareholders on a par with the social, community and environmental interests of third parties or stakeholders. They target threefold economic, social and environmental performance, and contribute to overall sustainable development by controlling the activities affecting stakeholders. Velde et al also state that a focus on social environmental issues can have a positive or negative impact on shareholders interests. A negative impact can be due to the integration of third party interests leading to sub-optimization of shareholder interests resulting in under-performance of share prices. A positive impact could be explained due to the integration of all stakeholders creating shareholder value by reducing non-financial risk and creating long-term growth opportunities for the firm. However, the effect on share prices of CSR activities is not clear.

Prior research has reported a relationship between CSR reporting and firm performance. According to the stakeholder theory, CSR reporting practices of firms affects the value of firm, which was considered in the conceptual framework in the context of Sri Lanka. Based on the above arguments it is suggested to test the following hypotheses:

$H0_d$: Corporate social responsibility reporting is not associated with higher firm performance.

H1d: Corporate social responsibility reporting is positively associated with higher firm performance.

The above hypotheses discuss the effect of corporate governance practices on firm performance because effective corporate governance is about adhering to best practice recommendations which suggests that boards should be comprised of a majority of independent non-executive directors, a separate leadership structure, board committees and accountability through appropriate disclosures which will be associated with higher firm performance.

Table 4.1

Summary of Hypotheses

Variables	**Ho**	**H1**
Leadership Structure	Separate leadership structure is not associated with firm performance.	Separate leadership structure is positively associated with firm performance.
Board Composition	A majority of non-executive directors on the board is not associated with firm performance.	A majority of non-executive directors on the board is positively associated with firm performance.
Board Committees	Boards committee structures composed of audit, remuneration and/or nomination committees are not associated with firm performance.	Boards committee structures composed of audit, remuneration and/or nomination committees are positively associated with firm performance.
Corporate Reporting Practices	Corporate social responsibility reporting is not associated with higher firm performance.	Corporate social responsibility reporting is positively associated with higher firm performance.

4.6 Firm Performance

Corporate governance is considered an important determinant of firm performance in the literature, which is also considered important in the context of Sri Lanka in this study. Firm performance in this study is represented by ROE, ROA and Tobin's Q. ROE and ROA are used to measure the operating performance based on shareholders equity and total assets of the company and explain the efficiency of management. Whereas Tobin's Q is used as a measure of market value of the firm and shows the effect of accounting information and voluntary disclosures on share prices.

According to the new conceptual framework, firm performance is measured by accounting-based measures and market-based measures. Good corporate governance practices affect firm performance. Therefore, firms that practice good corporate governance bring about better management resulting in monitored transparency and accountability and prudent allocation of company's resources, which enhances the financial performance resulting in a higher ROE and ROA, which in turn will result in higher share prices. Mobius (2002) reports that an increase in a company's share price, increases the market value of the firm. Hudson (2009) provides evidence in support of the above view, that company performance including the share price performance is related to the quality of corporate governance.

Fama et al. (1969) reports that favorable reactions to information are evidenced by an increase in share prices, whereas unfavorable reactions to information are evidenced by a decrease in share prices. If there is no price change around the time of the release of information, this implies that there is no reaction to the information. Therefore capital market research relies on the assumption that equity markets are efficient, and defines market efficiency according to the efficient market hypothesis, where the market adjusts rapidly to fully impound information into share prices. According to Deegan (2004), capital market research in accounting assumes that equity markets are semi-strong form efficient and rapidly and fully impound all publicly available information, including the information available in financial statements and other financial disclosures, into share prices in an unbiased manner.

Firm performance in Sri Lanka is also affected by capital market reactions to mandatory and voluntary disclosures, which is provided in the annual report of a company. Mandatory reporting is required by the regulation and CSR reporting is voluntary. Information content of voluntary reporting provided by the companies varies. However, disclosure of additional information reduces the cost of capital by reducing information asymmetry in the market, and reduces estimated risks associated with expected future returns and therefore the transaction costs. (Ghazali Mohd 2008). According to Healy and Palepu (2001), empirical research on the economic consequences of voluntary disclosures asserts three types of capital market effects for firms that make extensive disclosures. These are improved liquidity for their stocks in capital markets, reduction in their cost of capital and increased following by financial analysts.

The criteria by which firm performance is judged, differ between the concepts of shareholder approach and stakeholder approach. The objective of the shareholder approach is to maximize the firm's market value through allocative, productive and dynamic efficiency, whereas the stakeholder approach judges performance by a wider constituency interested in employment, market share and growth in trading relations with suppliers and purchasers, as well as financial performance (Mayer 1997).

From the above discussion, it follows that good governance practices are essential to firm performance, because the market value of shares is affected by mandatory and voluntary disclosures.

4.7 Conclusion

This chapter discussed the development of the hypothesis for the study. Firstly, it examined the theoretical framework that applies to the study. Secondly, the theoretical framework was linked to the conceptual framework through corporate governance and firm performance variables to develop the hypotheses for the study to observe if the corporate governance in Sri Lanka has an impact on firm performance. Thirdly, the hypotheses identified were discussed. Therefore, this chapter plays an important role in understanding the effect of corporate governance on firm performance in Sri Lanka. In the next chapter, we will present the methodology to test the hypotheses developed for the conceptual framework in this chapter.

Chapter 5

Research Methodology

5.1 Introduction

The purpose of this chapter is to describe the research methodology of this study. Since the aim of the study was to test the effect of corporate governance practices on firm performance, the design of the methodology was based on prior research into these relationships. This chapter describes the method of data collection, the variables used to test the hypothesis and statistical techniques employed to report the results.

The chapter is structured as follows. Section 5.2 discusses the research methodologies employed to introduce different research methods available and justify the research method adopted in this study. Section 5.3 discusses the sample selection and Section 5.4 explains the data collection methodology and types of data collected. Section 5.5 presents the design of variables for measurement, conceptualisation and operationalisation of the hypotheses. Section 5.6 discusses the statistical methods used to analyse the data and finally Section 5.7 presents the conclusion of the chapter.

5.2 Research Methodologies

In economic and social research the research method must be compatible with the theoretical paradigm. The term paradigm refers to the set of assumptions about the proper techniques for any specific inquiry. It refers to selection of what is to be studied, how the research is conducted, what should be studied, what data are collected and how it should be interpreted. The two main research paradigms used in social research are referred to as phenomenological or positivist.

In the phenomenological paradigm, researchers are seen as a part of the research process rather than being independent. It relies on people being studied to provide their own explanation of their situation or behaviour. The phenomenological approach is referred to as hermeneutic, qualitative, phenomenological, interpretive, reflective, inductive ethnographic or action research (Veal 2005).

The positivist paradigm takes the view that researchers are seen as independent of the research they are conducting. They view reality as objective and measureable; human beings are assumed to be rational; and research emphasizes facts and predictions and looks to explain cause and effects. The normal process for the positivist approach is to study the literature to establish a relevant theory and develop the hypotheses or propositions, which can be tested for association or causality by deducing logical consequences that are tested against empirical evidence. The positivist paradigm is also referred to as scientific, empiricist, quantitative or deductive.

The reasoning guiding a research design can be deductive or inductive. If the research process begins with examining of literature, developing the theoretical and conceptual structure, which is tested by empirical observation it is a deductive study, whereas in an inductive process, theory is developed from empirical observations (Collis & Hussey 2003).

The research method used to analyse data also depends on the paradigm adopted by the researcher. Although qualitative methods are associated with inductive reasoning and a phenomenological paradigm, and quantitative methods are usually applied to problems requiring a positivist and inductive approach, both qualitative and quantitative research methods are used by researchers.

Qualitative methods investigate how individuals think and react, and is directed towards deep understanding of their experiences, motivations and values. However, this method is often criticized as being too subjective, biased and lacking rigor.

Quantitative methodology espouses the collection of objective data, rigorous measurement and the use of statistical methods of analysis. It has the advantage of being able to generalize the results to large populations but is criticized for failing to explain 'why' the factors observed may have happened. This type of research fails to provide an in-depth understanding of the phenomenon under study.

The quantitative approach involves gathering and analysing numerical data, where as the qualitative approach involves examining and reflecting on perceptions in order to gain understanding of social and human activities.

Data for research derives from two main sources. Original data, which is referred to as primary data, is collected at the source. For example, survey data, questionnaires, observations and experimental data. Data which already exists is referred to as secondary data, such as annual reports, books, published statistics and internal records kept by companies (Veal 2005). Evidence required to test the hypotheses in this study is based on annual reports and published statistics. Therefore data derived for this study is from secondary sources.

This study is based on a positivist paradigm used deductive reasoning and quantitative techniques. This study adopted a positivist approach, because a positivist approach seeks facts or causes of social phenomena. The reasoning is deductive because the hypotheses were derived first and the data were collected later to confirm or negate the propositions. The selection of the sample, the sources of data, the procedure in collecting and coding the data, and the quantification of variables and method of data analysis are described below.

5.3 Sample Selection

The objective of the study was to conduct an investigation of the corporate governance practices of listed companies in Sri Lanka and their effect on firm performance, and the extent of adoption of corporate governance practices.

The sample was selected from the top 50 companies in the *Lanka Monthly Digest 50* (The LMD 50), listed in the Colombo Stock Exchange for the period 2003 and 2007.The aim was to compare the extent to which they had adopted corporate governance practices over the period. The top 50 companies in the LMD were selected because these were more likely to have the resources and motivation to take advantage of the opportunity to adopt good corporate governance practices. Reporting of corporate governance practices was voluntary during this period so the sample was limited to those companies which published a governance report in both 2003 and 2007. The top 50 companies presented annual reports, which included a governance report. Furthermore these companies were better performing, exhibited higher stock returns and were assumed to engage in good governance practices. The voluntary nature of reporting of corporate governance practices during the period studied meant that not all the companies reported on all or even some of the corporate governance practices in their annual reports. These were excluded from the sample. As this was a comparative study the final sample of 37 was determined by the number of companies that produced a report in both 2003 and 2007.

The study examined the data for the years 2003 and 2007. The reason for selection of the years was that the corporate governance guidelines were introduced in 2003. Four years later, 2007, was a suitable time period, in which companies who had adopted the practices could have been expected to show some change in adoption of the practices and if this had had an impact on company performance. Reporting of corporate governance practices was voluntary during this period. The code of corporate governance was mandated in 2007 to be effective for companies reporting on or after the 1st April 2008. Therefore, the year 2007 was an important year to examine the effectiveness of the voluntary code on performance. It was also a period when the economy was affected by adversities, yet the capital market performance was high

5.4 Data Collection

The following section discusses the method of data collection and types of data that were collected to conduct the study. The study assessed the relationship between corporate governance practices and firm performance of listed companies in Sri Lanka. The data and information required for the study were collected from the Colombo Stock Exchange (CSE) websites, annual reports, journals (The LMD 50) and the Colombo Stock Exchange publication *The Hand book of listed companies.*

5.4.1 Data Collection Methodology

Data on corporate governance and corporate reporting practices were collected from secondary sources. Financial data on performance were extracted from The LMD 50, which reports data on all the financial information relevant to the performance of the top 50 companies. Fact and figures relating to corporate governance and corporate reporting practices were extracted from annual reports and the Handbook of Listed Companies from CSE.

5.4.2 Types of Data collection

Corporate governance and reporting information were collected from annual reports and the *Handbook of Listed Companies*. For the purpose of this study data were collected for the period between 2003 and 2007. Data for 2003 reflects the corporate governance practices of firms prior to the issue of the voluntary code of best practices in 2003, and 2007 reflects the corporate governance practices of firms after the issue of the voluntary code of best practice in 2003.

The data required for the study included board leadership (if the positions of chairman and the CEO were held by single person or two separate persons), composition of the board (number of non-executive directors), board committees (details of the audit, remuneration and nomination committees) and corporate reporting practices of firms (financial and CSR reporting). Performance data used in the study were return on investment (ROE), return on assets (ROA) and Tobin's Q. The data on company size, which includes total assets and market capitalization were also extracted from The LMD 50 business magazine.

5.5 Design of the Variables: Operationalisation and Measurement of Variables

Described below are the variables used to operationalised the constructs discussed in chapter 4. They include the corporate governance variables (leadership structure, board composition, board committees and corporate social responsibility reporting) company performance and moderating variables of board size and firm size.

The corporate performance of this study was measured using accounting-based measures and market-based measures. ROE and ROA, which are considered as proxies for accounting measures in the study, and indicate the efficiency of generating profits from shareholders equity and the effective use of companies' assets in serving the shareholders economic interests respectively. Tobin's Q, which is a market-based measure will be used to indicate the market perception of the firm's performance (Weir, Laing & McKnight 2002).

In addition to the variables that are used to hypothesize the relationships, a number of variables that are important in determining firm performance in literature are also considered in this study, such as board size and firm size.

Table 5.1

Variables used to study the corporate governance practices in Sri Lanka

Variables	**Measures**	**Symbols**
<u>Corporate Governance</u>		
Separate leadership	Dummy variables 0 for combined leadership and 1 separate leadership	LDS
Board composition	Non-executive directors to number of directors	COMP
Board committees	Dummy variables 0 if less than two committees are represented and 1 if all three committees are represented	COMM
Corporate Reporting	Dummy variable 0 for financial reporting and 1 for CSR reporting	REP
<u>Firm performance</u>		
Tobin's Q	Market capitalisation + total assets - shareholders funds / total assets	TQ
Return on equity	Profit after tax / shareholders funds	ROE
Return on total assets	Profit after tax / book value of total assets	ROA
<u>Other</u>		
Board size	Number of directors	BSIZE
Market capitalisation	Price per share multiplied by total number of outstanding shares	MCAP
Total assets	Book value of total assets	TA

5.5.1 Leadership Structure

Literature on corporate governance widely uses dummy variables to operationalise the board leadership structure (Abdullah 2004; Haniffa & Hudaib 2006; Kiel & Nicholson 2003; Lam & Lee 2008). Therefore the current study will also represent dummy variables for board leadership structure. If one person occupies the role of chairman and the CEO, it will be classified as combined leadership and will be coded '0'. If the roles are occupied by two separate people it will be classified as separate leadership and will be coded '1'.

Empirical research on board leadership structure in Chapter 2 reports mixed results. But there is evidence in support of the separate leadership structure (Banks 2004; Brickley, Coles & Jarrell 1997; Monks & Minow 2004). Haniffa and Hudaib (2006) also report that companies which had a combined leadership structure did not perform as well as those with a separate leadership structure. This implies that the separation of the two roles is beneficial to firm performance, which is supported by agency theory.

The benefits of separation of the two positions was addressed by Cadbury (1992) and OECD principles of corporate governance (1999). The *Code of Best Practices on Corporate Governance* issued by ICASL and SEC in 2003 and 2008 also recommended separation of the two roles, because it results in better monitoring and implementation of strategy, and is capable of increasing the value of the firm. Therefore, the study supports a separate leadership structure for higher firm performance.

5.5.2 Board Composition

A commonly used approach to operationalize the board composition is the proportion of non-executive directors to total directors (Abdullah 2004; Dalton et al. 1998; Kiel & Nicholson 2003; Laing & Weir 1999; Leng 2004). In this study board composition is defined as the number of non-executive directors divided by the total number of directors on the board which will also be used in this study.

Studies by Baysinger and Butler (1985) and Rosenstein and Wyatt (1990) reported that boards with a higher proportion of outside directors are positively linked with firm performance. Since they are expected to be effective monitors of the executive members, a higher proportion of non-executive directors in the board will facilitate in independent decision-making, and therefore better performance, supporting the agency theory perspective.

To ensure the effectiveness of board of directors, the Cadbury code and the principle A.5.2 of *Code of Best Practices on Corporate Governance* issued by ICASL in 2003 and 2008 recommended that non-executive directors should be at least two or not less than one third of the board, whichever is higher. In the event that the same person holds the position of chairman and CEO, it is recommended that non-executives should comprise a majority of the board. To analyse compliance with the code of best practice a binary variable of 1 is assigned for compliance, with a ‘0’ for non-compliance.

5.5.3 Board Committees

Board committees include audit, remuneration and nomination committees. It was recommended by the Cadbury report (1992) that a board should include separate committees for auditing of the financial statements, monitoring the remuneration of executive directors and appointing new directors to the board. The above practices were also included in the 2003 and 2008 Code of Best Practice on Corporate Governance issued by ICSAL. Presence or absence of committees is presented by dummy variables in previous studies (Laing & Weir 1999). Therefore in the current study, if the firm has at least two of the committees of audit, remuneration and nomination, it is assigned a value of ‘1’, otherwise it is assigned a ‘0’.

The inclusion of oversight committees of the board is expected to have a positive influence on the motivation of directors, and increase confidence in financial statements and appointment of appropriate caliber of directors to the board, thus improving the corporate governance of firms. Laing and Weir (1999) found that firms with audit and 5remuneration committees performed better, and. Dalton et al. (1998) also reported inclusion of remuneration committees resulted in better performance. Therefore this study supports the board committee structure for better performance.

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5.5.4 Corporate Reporting

Corporate reporting includes financial reporting and information beyond that required by regulation. Therefore, reporting on CSR activities of the firm are information that will be voluntarily disclosed. Corporate reporting practices will be represented by dummy variables in the study. Similar methodology has been used in prior studies on corporate governance (Keil & Nicholson 2003: Weir & Laing 2001). The value of the variable is “1” if the firm report on socially responsible activities in their annual reports, and “0” if they only report on financial information in their annual reports.

It is posited in the academic literature, that certain governance mechanisms can increase or reduce the level of voluntary disclosures by management in the annual reports (Donnelly & Mulcahy 2008). Boards comprised of a majority of non-executive directors and separate leadership have been related to management voluntary disclosures (Donnelly & Mulcahy 2008; Huafang & Jianguo 2007), which supports the relationship between CSR reporting and board independence.

In developing countries like Sri Lanka, corporate social responsibility can have an impact on firm performance because the specific CSR activities can have a positive effect on society and hence can improve firm performance. Therefore the study supports a positive relationship for CSR reporting and firm performance.

5.5.5 Board Size

We consider board size as a variable that can influence corporate governance practices and firm performance in this study. It is acknowledge that the board size and firm size are correlated (Dalton et al. 1999; Yarmack 1996) and board size is related to firm performance (Kiel & Nicholson 2003). From an agency perspective, larger companies require bigger boards to monitor and control the managements actions (Kiel & Nicholson 2003). As suggested by agency theorist (Jensen 1993), an optimal limit should be around eight directors and Lipton and Lorsch (1992) suggested the maximum size of the board should be ten members, as greater numbers will interfere with the group dynamics and hinder board performance. An alternative view is that it is not the size that is important, rather it is the number of outside directors (Dalton et al. 1999). Therefore in the academic literature, this variable is measured using total number of directors (Abdullah 2004; Kiel & Nicholson 2003). The same method will be used in this analysis.

5.5.6 Firm Size

Firm size may be related to corporate governance characteristics and may be correlated with firm performance. Firm size can be represented by market capitalization and book values of total assets of the firm.

Market Capitalization

The size of a company measured by market capitalization represents the total value of a company. Market capitalization is a market estimate of the value of a company, based on perceived future prospects, and economic and monetary conditions. It is calculated by multiplying the current price per share by the total number of outstanding shares. Investor confidence is reflected in the market capitalization.

Investment in companies with higher market capitalization has lower risk compared to the firms with lower market capitalizations, because shares of firms with higher market capitalization are more liquid. Alternatively firms with lower market capitalization may be profitable due to a higher growth potential. The risk factor attached to shares of companies with lower market capitalization may be high, even though they have higher financial returns (Rashid 2007). Prior empirical studies find that firm performance is positively related to market capitalization (Yarmack 1996).

Total Assets

As stated previously, firm size can also be measured by the book value of firms' total assets. Previous research has used total assets to represent firm size. Firm size can be related to other governance variables. Pathan et al. (2007) states that a statistically significant correlation was reported for board size and total assets. Keil and Nicholson (2003) found total assets of a company were positively correlated to board size and board composition. Therefore the total assets are considered to have an impact on the variables used in this study.

5.5.7 Performance Measures

The existing literature on corporate governance practices has used accounting-based performance measures, such as return on equity (ROE) and return on assets (ROA), and market-based measures, such as Tobin's Q, as proxies for firm performance (Abdullah 2004; Bhagat & Black 2002; Daily & Dalton 1993a; Hermalin & Weisbach 1991; Lam & Lee 2008; Yarmack 1996). Firm performance in this study is measured in terms of the profitability and value of a firm. Since we aim to study the impact of corporate governance mechanisms on firm performance, we take the measures widely used for listed companies, namely, ROE, ROA and Tobin's Q, which are also considered in this study as proxies for accounting return and market return.

Tobin's Q

Tobin's Q is measured using the firm's market value to book value ratio. It is a measure of growth prospects of assets, defined by the future profitability of the assets in relation to their replacement value (Leng 2004). Bhagat and Jefferis (2002), refers to Tobin's Q as the current market value of the company divided by the replacement cost of the assets, which is measured by the book value of the firms assets. Market value is calculated in a different way by different researchers. In their study on Banking Industry, Adam and Mehran (2005) calculate the market value of the firm as the book value of assets minus the book value of equity, plus the market value of equity.

Tobin's Q compares the ratio of a company's market value and the value of a company's assets. If the value of the Tobin's Q is equivalent to 1.0, it indicates that the market value is reflected in the assets of the company. A ratio greater than 1.0 indicates market value is higher than the company's recorded assets. Therefore a higher Tobin's Q encourages companies to invest more capital, because the value of the company is more than the price they paid. This creates more value for shareholders. On the other hand, a Tobin's Q of less than 1.0 indicates that the market value is lower than the assets of the company which suggests that the market may be undervaluing the company.

Tobin's Q is a proxy for how closely the managers and shareholders interests are aligned. Therefore the higher the Q value, the more effective the governance mechanism and the better the market perception of the company. A lower Q values suggests a less effective governance mechanism and greater managerial discretion (Weir, Laing & McKnight 2002). This study employs the methodology used by Adam and Mehran (2005) and Rashid and Islam (2008) to calculate Tobin's Q, which is as follows:

$$\text{Tobin's Q} = \frac{\text{Market capitalisation + Total assets - shareholders funds}}{\text{Total assets}}$$

Return on Equity (ROE)

Return on equity measures the rate of return on shareholders equity. It shows how well the company uses the shareholders investments to generate earnings. This measures the efficiency of generating profits from each dollar of shareholders equity. A higher ratio indicates a higher return. It is expected that there will be a positive relationship between corporate governance, corporate reporting practices and firm performance. ROE is calculated as follows:

$$\text{ROE} = \frac{\text{Profit after tax}}{\text{Shareholders' funds}}$$

Return on Assets (ROA)

Return on assets shows the profitability of the company's assets in generating profits.
It indicates the effectiveness of the companies assets in increasing shareholders economic interests (Haniffa & Hudaib 2006). It also shows the efficiency of management in using its asset to generate earnings. ROA is calculated as follows:

$$\text{ROA} = \frac{\text{Profit after tax}}{\text{Total Assets}}$$

5.6 Statistical Analysis

Preliminary analysis of the data was carried out for the years 2003 and 2007. At this stage, firms with missing information were excluded from the study and the final sample was reduced to 37 listed companies from The LMD 50. To test the relationships suggested in the hypotheses stated in the conceptual framework, the SPSS statistical program was employed. The analysis included descriptive statistics, two-related-sample t-tests, Spearman's correlation and analysis of variance.

Other studies on the relationships between corporate governance practices and firm performance have previously been conducted using regression analysis or ANOVA. Regression analysis is appropriate when the aim is to predict the causal relationships between one or more independent and a dependent variable. In the research conducted for this thesis, a purpose was not to predict the factors that cause a change in governance but to determine (a) whether a change in the variables (corporate governance practices) had taken place by 2007 as a result of the intervention that was introduced in 2003 and (b) what those changes were. In this case the analysis examined the differences occurring in the time between observations of the same sample. The analysis used in the thesis, analysis of variance (ANOVA), .which is based on comparing the differences in the means and the variances between observations, is an appropriate statistical method in this research for determining if there were statistically significant differences between the observations.

The corporate governance code was introduced in Sri Lanka in 2003 but until 2007 companies were not required to report their corporate governance practices. As a result not many had produced a governance report at both time periods. The top 50 companies were selected because they presented annual reports, which included a governance report. As this was a comparative study, the same companies were selected at each of the time periods, 2003 and 2007. The final sample was reduced to 37 companies due to missing data. Because of the small size of the sample, regression analysis to determine any relationships between the variables would have been invalid. Minimum sample size determination for regression analysis is not satisfied in the sample (Bartlett et al. 2001).

Furthermore this study employed descriptive statistics report the extent to which companies adopted corporate governance practices in Sri Lanka between 2003 and

2007; T-tests for the significance in the difference between two variables; correlation to measure the strength of association between variables. Empirical studies show, similar methodology was used in previous studies (Kiel & Nicholson 2003; Laing & Weir 1999)

5.6.1 Descriptive Statistics

Descriptive statistics have been widely used in academic research on corporate governance (Abdullah 2004; Laing & Weir 1999; Lam & Lee 2008; Vafeas 2000). Descriptive statistics measure the central tendency and dispersion. The most commonly used measures of central tendencies are mean, mode and median. The mean is the most important measure of central tendency. (Veal 2005). The descriptive statistics used in this study consist of mean, maximum and minimum. The mean is calculated to measure the central tendency of the variables in 2003 and 2007.

Descriptive statistics are also useful to make general observations about the data collected. They report on the trends and patterns of data and provide the basis for comparisons between variables. In this study descriptive statistics provide a comparison of changes in the data for 2003 and 2007. They show the extent to which companies have adopted the recommendations of the code of best practice on corporate governance and the trends of the firm performance variables.

The mean is the sum of all observations divided by the number of values.
The equation is as follows:

$$\overline{x} = \frac{\sum_{1}^{n} x_i}{n}$$

$\overline{x}$ = sample mean

n = number of observations

$\sum_{1}^{n} x_i$ = sum of all the observations

The maximum is used to compare the highest value and the minimum is used to compare the lowest values of the variables in 2003 and 2007.

It is expected that the firms in 2007 will have a higher mean value for corporate governance practices as a result of listing rules requiring the companies to report on corporate governance practices recommended by the code of best practice on corporate governance in 2003. Higher mean values for ROE, ROA and Tobin's Q indicate higher performance of the companies.

5.6.2 T-Test

T-tests can be used to determine whether there is a significant difference between two sets of means. Therefore t-tests using SPSS statistical program were employed in this study.

Conducting the t-tests requires that the normality of the data is not violated. Therefore to test the normality of the distribution for the data, Shapiro-Wilk's and K-S Lilliefors test for normality was conducted. They test the null hypothesis, that the data came from normally distributed population (Wikipedia). When the sample size is small, one may be unable to reject the normality assumption even if it is wrong. If the tests report reasons to doubt the assumption of normality, the assumption of a parametric test would be violated.

Therefore, non-parametric tests were conducted because they make limited assumptions about the distribution of the data. AWilcoxon Signed Rank Test can be used whenever the distributional assumptions underlying the t-test are not satisfied (Wikipedia). A Wilcoxon Signed Rank Test (Two-Related-Sample Test), which is the non-parametric version of paired sample t-test (Carver & Nash 2006), was conducted to test the significance of the means of the variables for 2003 and 2007,

Two-Related-Sample t-tests are used when there are repeated measurements for the same sample (Carver & Nash 2006). Two-Related Sample t-test were conducted to find out if the differences in the corporate governance characteristics in 2003 and 2007 are significant. Laing and Weir (1999) and Abdullah (2004), used similar approaches in their studies on corporate governance and firm performance.

Wilcoxon signed rank test procedure:

$2n$ = two observations of each of the n subjects. Let i denote the particular subject that is being referred to and the first observation measured on subject i be denoted by x_i and second observation be y_i.

Let Zi = Yi - Xi for i = 1, ... , n. The differences Zi are assumed to be independent.

Each Zi comes from a continuous population (they must be identical) and is symmetric about a common median θ.

The null hypothesis tested is H_0: $\theta = 0$. The Wilcoxon signed rank statistic W+ is computed by ordering the absolute values |Z1|, ..., |Zn|, the rank of each ordered |Zi| is given a rank of Ri. Denote φi = I(Zi > 0), where I(.) is an indicator function.

The Wilcoxon signed ranked statistic W+ is defined as:

$$\mathbf{W}_{+} \sum_{i=1}^{n} \varphi_i R_i$$

(http://en.wikipedia.org/wiki/Wilcoxon_signed-rank_test)

5.6.3 Spearman's Rank Correlation

Also used in this study are the correlation coefficients which measure the strength of the linear association between two variables. When the data are not normal, includes ordinal data, and the researcher suspects a linear relationship, non-parametric measures such as Spearman's Rank Correlation can be used to measure the strength of association. This approach has been used in previous research which measures the strength of the linear association between corporate governance and firm performance studies (Abdullah 2004; Vafeas 2000).

The analysis of the data found departures from normality in the distribution and also included ordinal data. Therefore non-parametric test of Spearman's Rank Correlation was conducted to measure the strength of association between corporate governance variables and firm performance in this study.

Spearman's rank correlation is calculated as follows:

$$r_s = 1 - \frac{6\sum d^2}{N(n^2-1)}$$

Where *d is the* difference between the two ranked variables, *n* is the number of data pairs and ∑ is the the sum of

5.6.4 Analysis of Variance

In order to test the hypotheses about the relationships between the corporate governance variables and firm performance variables, an analysis of variance (ANOVA) using GLM Multivariate or Univariate Analysis procedures will be conducted. This procedure compares the mean of dependent variables for groups defined by the factor variables and whether there is an interaction between two variables in this study.

ANOVA is an exploratory analysis, which tests the differences among sets of means grouped by more than one classifying variable or factor. It examines the cross-tabulation of means and determines whether the differences revealed are significant. It is used when there are a number of independent variables, and each is contributing to some aspect of the make-up of the phenomenon (Veal 2005). When the effect of one factor is not the same for all the other categories of the factors, interaction is present. The primary goal of ANOVA is to explain the variation in a response by distinguishing a hypothesized effect, or combination of effects from a null hypothesis of no effect. The effect of factor A on variation in Y is determined by testing the null hypotheses.

$$Y= A + B + B*A + C + C*B +C*B*A + \varepsilon$$

where, Y is the firm performance variable, A, B, C are Corporate Governance variables, and ε is the error term.

Analysis of variance uses F statistics to compute the probability *p*. The F ratio is the mechanism used to test the null hypotheses, which test that the mean of groups do not differ significantly. If *p* is less than a pre-determined threshold (for example, $\alpha = 0.10$) the null hypotheses is rejected and the factors are deemed to have a significant effect (Doncaster & Darvey 2007).

The assumption required for analysis of variance is that it must be an independent sample from normal a population with the same variance. To test the normality and homogeneity, the Kolmogorov-Smirnov test and Levene's test are conducted. Kolmogorov-Smirnov test assesses if there are significant departures from normality in the population distribution. The Levene's test for homogeneity assesses if the population variance for the group are significantly different from each other (Carver & Nash 2006). These tests have been incorporated in the SPSS procedures.

The strength of ANOVA lies in its capacity to distinguish effects on a response from among many different sources of variations compared simultaneously, or in certain cases through time. It can identify interacting factors and it can measure the scale of variation within a hierarchy of effects. This versatility makes it a potentially powerful tool for answering questions about causality (Doncaster & Darvey 2007).

$Y = A + B + B*A + \varepsilon$ (Univariate analysis)
where Y is a firm performance variable, A, B are corporate governance variables,
and ε is the error term.

$Y = A + B + B*A + C + C*A + C*B + C*B*A + \varepsilon$ (multivariate analysis)
where Y is a firm performance variable, A, B,C are corporate governance variables,
and ε is the error term.

5.7 Conclusion

The current chapter discussed the methodology to be used to test the hypotheses suggested in this study. It included the selection of the sample, data collection, and the, design of the variables, their measurement and, operationalization. Furthermore, the methodology employed to collect the data, and statistical techniques used to analyse the data to test the relationship between corporate governance variables in affecting firm performance in Sri Lanka, was also discussed. The results from the statistical tests employed will be discussed in the next chapter.

Chapter 6

Statistical Results and Analysis

6.1 Introduction

The analysis of the relationship of corporate governance variables and firm performance variables is discussed in this chapter using the data from the sample. The analysis uses descriptive statistics to compare changes in compliance between 2003, and 2007 and, T-tests will report the significance of the change. Spearman's correlation analysis assesses the association between variables, and an analysis of variance assesses the suggested relationships in the research hypotheses in Chapter 4. The results from the statistical analysis discuss the integrated results to find out if the hypotheses are supported.

The structure of the chapter as follows. Section 6.2 reports on the descriptive statistics. Section 6.3 reports the t-tests, Section 6.4 reports Spearman's correlation and Section 6.5 reports the analysis of variance. An integrated analysis of the results is presented in Section 6.6. Section 6.7 presents the conclusion to the chapter.

6.2 Descriptive Statistics for Corporate Governance Variables in Sri Lanka

As discussed in Chapter 5, descriptive statistics for 2003 and 2007 were calculated for corporate governance variables and firm performance variables in the study. Descriptive statistics compared the compliance by the companies with corporate governance best practice recommendations in 2003 and 2007. They also described the characteristics of board structure and corporate reporting practices prevalent among listed companies in Sri Lanka and the variables used to measure firm performance. A summary of the descriptive statistics are presented in the Table 6.1 and Figure 6.1.

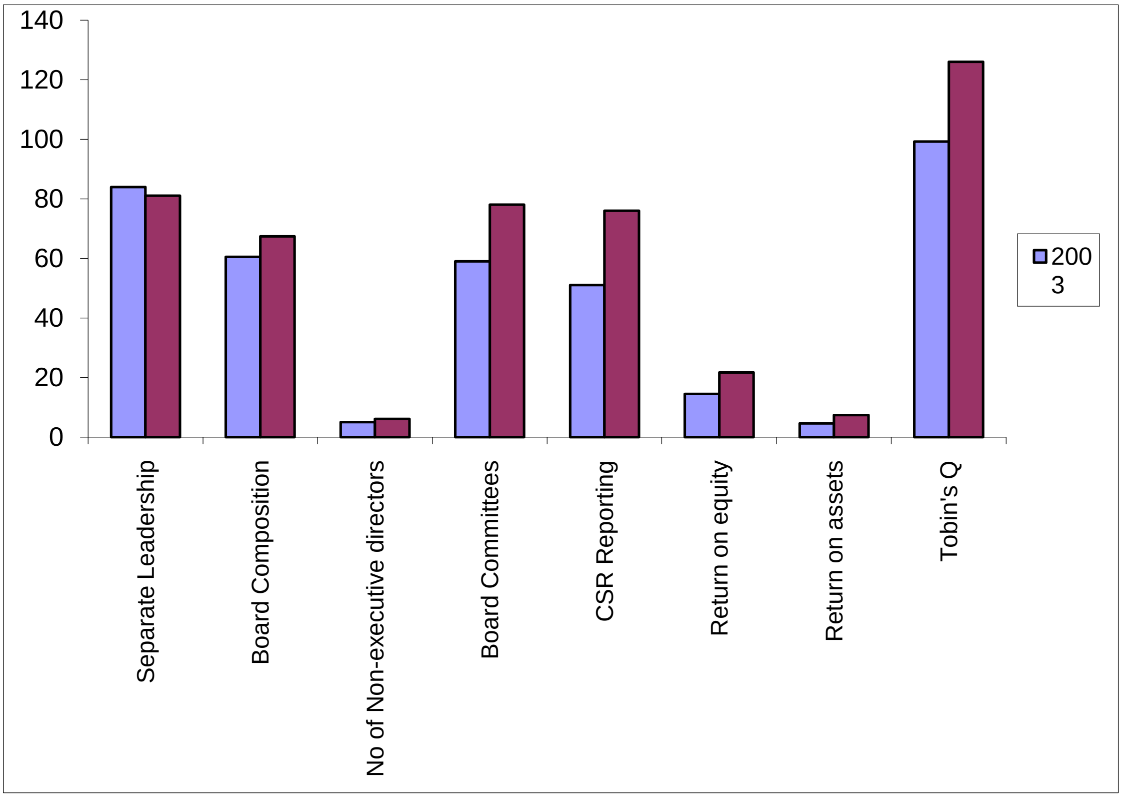
Table 6.1

Descriptive Statistics for 2003 and 2007

Variables	2003 Minimum	2003 Maximum	2003 Mean	2007 Minimum	2007 Maximum	2007 Mean
Separate leadership (%)	0	1	84	0	1	81
Board composition (%)	29	91	61	20	92	67
No. of Non-exec directors	0	10	5	2	12	6
Compliance: Non –exec rep (%)	0	1	95	1	0	97
Board committees (%)	0	1	59	0	1	78
CSR reporting (%)	0	1	51	0	1	76
Board size	4	14	8.43	4	15	9.27
Market capitalization	282	21658	3053	855	97945	11550
Total assets	1727	119810	17930	2547	224061	38125
Return on equity (%)	-14	45	14.43	3	97	21.73
Return on assets (%)	-4	23	4.58	1	37	7.38
Tobin's Q	0.62	2.08	0.99	0.58	4.39	1.26

Figure 6.1

Descriptive Statistics for 2003 and 2007



6.2.1 Leadership Structure

Analysis of the leadership structure for 2003 and 2007 (Table 6.1) reports that 84% of the firms separated the leadership roles in 2003 and this decreased to 81% in 2007. However, over 80% of the firms in the sample identified the importance of separating the position of chairman and CEO and are complying with the code of best practice recommendations issued in 2003 by ICASL and SEC. Less than 20% of firms are still combining the posts of CEO and the chairman. Examination of the data also shows that some companies have moved back to combined leadership and have included majority of non-executive directors on the board or a lead director, whereas some have moved from combined leadership to separate leadership structures.

6.2.2 Board Composition

Board composition, which is the proportion of non-executive directors on the boards, shows that there is a large variation in the percentage of non-executive directors on the boards in both years (Table 6.1). In 2003, the number of non-executive directors ranged from a minimum mean of 29% to a maximum mean of 91%, and in 2007 it ranged from a minimum mean of 20% to a maximum mean of 92% The mean of proportion of the non-executive directors on the boards increased from 61% in 2003 to 67% in 2007, which is a relatively small increase.

Furthermore, the number of non-executive directors on the board ranged from 0 to 10 in 2003 and 2 to 12 in 2007. The average number of non-executive directors was 5 in 2003 and 6 in 2007, which is above the minimum recommended by the ICASL code of best practice of 2003. The results also showed that the percentage of companies, which complied with the recommendations in 2003, was 95%, and this increased to 97% in 2007.

6.2.3 Board Committees

The appointment of remuneration, audit and nomination committees were recommended by the code. In 2003, 60% of companies had audit, remuneration and/or nomination committees. This figure increased to 78% in 2007, which showed that the number of companies complying with the code of best practice on corporate governance had increased.

6.2.4 Corporate Reporting

Corporate reporting (REP) practices presents reporting on corporate social responsible activities (CSR) by the companies in Sri Lanka. CSR reporting by the firms in the sample increased from 51% in 2003 to 76% in 2007.

6.2.5 Board Size

Board size (BSIZE) as reported in descriptive statistics, has not varied significantly from 2003 to 2007. The minimum size of a board reported in 2003 was 4 and maximum size was 14. The minimum size of a board reported in 2007 was 4 and maximum size was 15. The average size of a board in 2003 and 2007 was 8 and 9 respectively.

6.2.6 Firm Size

Firm size is represented by market capitalisation and total assets. The minimum value for market capitalisation (MCAP) for companies in the sample in 2003 was 282 and the maximum value was 21,658, and in 2007 the minimum value was 855 and the maximum value in the sample was 97,645. The mean has increased from 3053 in 2003 to 11,550 in 2007. The descriptive statistics show that market capitalisation of the companies in the sample has increased significantly. Higher market capitalisation suggests increased investor confidence in firms in the sample.

Total assets (TA) of the companies in the sample shows a minimum of value of 1727 million, a maximum value of 119,810 million and a mean value of 17,930 million for 2003. The minimum for 2007 is 2547 million, the maximum is 224,061 million and the mean value is 38,124 million.

6.2.7 Return on Equity

ROE averaged around 14.43% in 2003 with a minimum value of –14% to a maximum value of 45%. The mean value of return on equity increased in 2007 to 21.73% with a minimum value of 3% and a maximum value of 97%. Results of descriptive statistics show performance based on shareholders equity increased in 2007.

6.2.8 Return on Assets

The mean value for ROA was 4.58%, with a minimum of –4% and a maximum of 23% for 2003. In 2007, the mean increased to 7.38%, with a minimum of 1 and a maximum of 37% for 2007. Results report that the profitability based on total assets increased in 2007.

6.2.9 Tobin's Q

As stated in the previous chapter, Tobin's Q measures market performance. A Tobin's Q value of greater than 1 represents a positive investment opportunity. The mean value for Tobin's Q for 2003 was 0.99, with a minimum value of 0.62 and a maximum value of 2.08. In contrast, the mean value for 2007 was 1.26, with a minimum value of 0.58 and maximum value of 4.39. The results of Tobin's Q show that market value of the firm increased over the years.

Descriptive statistics in this study show the extent to which companies in Sri Lanka complied with governance structures and corporate reporting practices. The accounting–based measures of ROE are greater than ROA. The market-based measure of firm performance, Tobin's Q, showed a significant increase during the period under review. Finally, these results indicate that corporate performance measured by all three ratios increased over the years.

6.3 Two-Related-Sample T-test

Comparison of the mean values of corporate governance characteristics and the performance of the companies in the samples for years 2003 and 2007 using two-related-sample t-test are presented in Tables 6.2 and 6.3. The details of the results are as follows.

Table 6.2

Board Characteristics –Comparison of Mean Value for 2003 and 2007

Variables	**2003**	**2007**	**Z**	**Sig. (2-tailed)**	**Significance Level of difference in means (%)**
Leadership Structure	0.84	0.81	0.378	0.705	not significant
Board Composition	0.61	0.67	-3.067	0.002	.05
Non-exec. Director	5.05	6.11	-3.747	0.000	.05
Board Committees	0.59	0.78	-2.333	0.02	.05
Corporate Reporting	0.51	0.76	-2.496	0.013	.05
Board Size	8.43	9.27	-3.079	0.002	.05

6.3.1 Leadership Structure

Comparison of the mean difference in the leadership structure in 2003 and 2007 is not significant ($z = 0.378$, $p > 0.05$), which was reported by the fall in the mean from 84 percent in 2003 to 81 percent in 2007. This indicated that the number of companies complying with the introduction of the code of best practice on corporate governance issued by ICASL in 2003 to separate the position of chairman and CEO has not changed significantly.

6.3.2 Board Composition

The number of firms complying with non-executive director representation on boards between 2003 and 2007 was significant ($z = - 3.067$, $p < 0.05$). The total number of non-executive directors representing the board was also significant ($z = - 3.747$, $p < 0.05$), indicating that the companies in the sample are increasingly conforming to the code of best practice on corporate governance.

6.3.3 Board Committees

Compliance with the committee structure recommended by the code of best practice on corporate governance has increased significantly ($z = - 2.333$, $p < 0.05$). This indicates that there was an increase in the presence of audit, remuneration and/or nomination committees by the companies represented in the sample between 2003 and 2007. The companies in the sample not only moved towards structures recommended by the code of best practice on corporate governance, but the changes were statistically significant.

6.3.4 Corporate Reporting

CSR reporting practices of the companies in the sample increased since 2003. The mean difference in reporting practices between 2003 and 2007 was significant ($z = -2.496$, $p < 0.05$). T-tests confirmed that the companies in the sample reporting on CSR practices in their annual reports increased significantly.

6.3.5 Firm Performance

Comparison of mean values for performance indicators ROE, ROA and Tobin's Q are reported in Table 6.3. ROE ($z = -3.121$, $p < 0.05$), ROA ($z = -2.541$, $p < 0.05$) and Tobin's Q ($z = -4.258$, $p < 0.05$) were significant, indicating that the performance increased significantly for the top 50 listed companies in Sri Lanka from 2003 to 2007.

Table 6.3

Firm Performance - Comparison of mean value for 2003 and 2007

Variables	2003	2007	Z	Sig (2-tailed)	Significance Level of difference in means (%)
Return on equity	14.43	21.73	-3.121	0.002	.05
Return on assets	4.58	7.38	-2.541	0.011	.05
Tobin's Q	0.99	1.26	-4.258	0.000	.05

6.4 Spearman's Correlation

Table 6.4 presents Spearman's correlation for all the variables in the study. It examined the association between the corporate governance variables and firm performance variables. Overall, the correlations were low for both 2003 and 2007. But there are a number of statistically significant relationships. Note that the data does not suggest multicollinearity problems, which usually require correlations between variables of 0.80 or more.

Table 6.4

Spearman's Correlation

Panel A: 2003

	LDS	COMP	NONEX	COMM	CSR	BSIZE	MCAP	TASS	ROE	ROA	TQ
LDS	1										
COMP	0.059										
NONEX	0.215	.801**									
COMM	0.085	0.292***	.375*								
CSR	0.159	0.175	.332*	.628**							
BSIZE	0.3***	0.04	.585**	0.167	0.257						
MCAP	0.065	0.201	0.132	.371*	.377*	-0.024					
TA	-0.038	.418*	.488**	.449**	0.241	0.294***	.565**				
ROE	0.096	0.118	0.096	.349*	.363*	-0.094	.499**	0.252			
ROA	0.028	-0.249	0.314***	0.044	0.161	0.304***	.331*	0.286***	.585**		
TQ	0.113	0.253	0.103	0.062	0.096	-0.175	.458**	.353*	.487**	0.127	**1**

Panel B: 2007

	LDS	COMP	NONEX	COMM	CSR	BSIZE	MCAP	TASS	ROE	ROA	TQ
LDS	1										
COMP	.360*										
NONEX	0.295***	.858**									
COMM	-0.086	0.08	0.137								
CSR	-0.274	0.154	0.212	0.008							
BSIZE	0.003	-0.075	.339*	0.191	0.135						
MCAP	0.026	0.225	0.266	0.166	0.083	0.12					
TA	0.123	0.207	.376*	0.135	0.065	.440**	.513**				
ROE	.365*	0.134	0.097	-0.182	-0.003	-0.005	0.082	-0.175			
ROA	0.029	-0.101	-0.152	-0.062	-0.068	-0.174	0.014	-.565**	.608**		
TQ	0.061	0.124	0.11	0.055	0.168	-0.106	.554**	-0.148	.404*	.395*	1

***. Correlation is significant at the 0.05 level (2-tailed).**

****. Correlation is significant at the 0.01 level (2-tailed).**

*****. Correlation is significant at the 0.10 level (2-tailed).**

The results suggested that separate leadership structure was not significantly correlated with performance variables ROE, ROA and Tobin's Q in 2003 but correlation was significant with ROE in 2007. Separate leadership structure was also significantly correlated with board composition and number of non-executive directors in 2007, suggesting that board independence is associated with separate leadership structure. It was also significantly correlated with board size in 2003.

Board composition was significantly correlated with the presence of committees and the size of the firm measured by the total assets of firms in 2003, but was not correlated with firm performance based on accounting-based measures or market-based measures in 2003 or 2007. Even though the number of non-executive directors was positively and significantly correlated with the presence of committees, corporate reporting, board size and total assets was negatively correlated to ROA in 2003, and it was only significantly correlated to board size and total assets in 2007. Correlation analysis did not report any association between board composition and firm performance among the top 50 listed companies in Sri Lanka for 2003 or 2007.

The presence of board committees was significantly correlated with corporate reporting, market capitalisation, total assets and ROE in 2003, but was not significantly correlated with any variables in 2007.

Corporate reporting was significantly correlated with market capitalisation and ROE in 2003, but there was no significance in correlation for corporate reporting in 2007.

Board size was correlated with total assets and ROA in 2003, but it was only correlated to total assets in 2007.

However, correlation test results did not support firm performance based on Tobin's Q and ROA for separate leadership structure, board independence or CSR reporting for companies in the sample. But ROE supported the corporate reporting for 2003 and leadership structure for 2007.

6.5 Analysis of Variance (ANOVA)

In order to test the hypotheses, analysis of variance was employed. Analysis of variance investigated the interaction between board structure, corporate reporting and firm performance.

The method that was applied to analyse the variance was multivariate and univariate analysis. Multivariate analysis was conducted for leadership structure, board composition, corporate reporting, board committees, corporate governance index and firm performance variables of ROE, ROA and Tobin's Q. Univariate analysis was conducted for board size, leadership structure and board composition, number of non-executive directors and firm size.

Both multivariate analysis and univariate analysis, using F statistics, indicated that the relationship between corporate governance variables and firm performance was statistically significant. These are described in detail below.

6.5.1 Leadership Structure and Firm Performance

The results of the analysis of variance conducted to find the interaction between leadership structure and firm performance reported mixed results (Table 6.5). The relationships were not significant for 2003. However, in 2007 separate leadership structure was significant for ROE with F-statistics 10.782 ($p = 0.011, < 0.05$). Neither ROA nor Tobin's Q was significant for separate leadership structure in 2007. However, based on the significant relationship between ROE and leadership structure, null hypothesis ($H0_a$) is rejected and it can be concluded that there is a positive relationship between separate leadership structure and firm performance, accepting the alternative hypothesis (H1a).

Table 6.5

Analysis of Variance for Board Leadership Structure and Firm Performance

Firm Performance Variable	**Corporate Governance Variable**	**2003**		**2007**	
		F	**Sig.**	**F**	**Sig.**
Return on equity	Leadership structure	0.398	**0.551**	10.782	**0.011**
Return on assets	Leadership structure	2.788	**0.146**	0.134	**0.724**
Tobin's Q	Leadership structure	0.192	**0.677**	0.894	**0.372**

6.5.2 Board Composition and Firm Performance

Analysis of variance was also performed to find the interaction between board composition and firm performance (Table 6.6). Results did not show any significant relationship with performance indicators for 2003. But F-statistics reported that board composition was significantly related to ROE, with F-statistics 14.028 (p = 0 000, < 0.05), Tobin's Q with F-statistics 11.827 (p = 0.001, < 0.05) and ROA with F-statistics 2.458 (p = 0.096, < 0.10) for 2007. Therefore, the null hypothesis ($H0_b$) was rejected and it was concluded that boards dominated by non-executive directors result in higher performance, accepting the alternative hypothesis (H1b).

Table 6.6

Analysis of Variance for Board Composition and Firm Performance

Firm Performance Variable	**Corporate Governance Variable**	**2003**		**2007**	
		F	**Sig.**	**F**	**Sig.**
Return on equity	Board composition	0.723	**0.728**	14.028	**0.000**
Return on assets	Board composition	1.135	**0.473**	2.458	**0.096**
Tobin's Q	Board composition	0.313	**0.976**	11.827	**0.001**

6.5.3 Board Committees and Firm Performance

Analysis of variance also reported an interaction relationship between board committees and firm performance (Table 6.7). The results did not find any significant relationship for the year 2003. However, the results showed a significant relationship for ROE with F-statistics 20.332 (p = 0.002, < 0.05) and Tobin's Q with F-statistics 5.746 (p = 0.043, < 0.05) for 2007. Therefore, the null hypothesis ($H0_c$) was rejected and it was concluded that there is a positive relationship between board committees and firm performance accepting the alternative hypothesis (H1c).

Table 6.7

Analysis of Variance for Board Committees and Firm Performance

Firm Performance Variable	Corporate Governance Variable	2003 F	2003 Sig.	2007 F	2007 Sig.
Return on equity	Board committees	0.199	**0.672**	20.332	**0.002**
Return on assets	Board committees	1.674	**0.243**	3.055	**0.119**
Tobin's Q	Board committees	0.807	**0.404**	5.746	**0.043**

6.5.4 Corporate Reporting and Firm Performance

Finally, analysis of variance reported an interaction between corporate social responsibility reporting and firm performance, for 2003 (Table 6.8). F-statistics also showed that companies, which reported on CSR, performed better with ROE, F-statistics 2.934 ($p = 0.096, < 0.10$), and ROA, F-statistics 4.238 ($p = 0.047, < 0.05$) in 2003. But there was no significant relationship found for CSR reporting and firm performance in 2007, accepting the null hypothesis ($H0_d$).

Table 6.8

Analysis of Variance for Corporate Reporting and Firm Performance

Firm Performance Variable	Corporate Governance Variable	2003 F	2003 Sig.	2007 F	2007 Sig.
Return on equity	CSR reporting	2.934	**0.096**	0.147	**0.704**
Return on assets	CSR reporting	4.238	**0.047**	0.170	**0.682**
Tobin's Q	CSR reporting	0.080	**0.780**	1.086	**0.305**

Finally, market capitalisation and total assets were included in the analysis of variance to test if the size of the firm had an effect on board structure and corporate reporting practices. The size of the company as a variable had no significant effect on firm performance for the companies in the sample. Therefore these variables were removed from the final analysis.

6.6 Integrated Analysis of Results

Results of the statistical analysis on descriptive statistics, t-tests, Spearman's correlation and analysis of variance are discussed in the current section. The discussion integrates the results to support the hypotheses posited in Chapter 4. The resulting relationships predicted in the hypotheses on corporate governance and firm performance are also discussed in the following section.

6.6.1 Firm Performance

Firm performance indicators used in this study were ROE and ROA as measures of operating performance, and Tobin's Q as a measure for market valuation. The descriptive statistics in Table 6.1 showed that ROE was greater than ROA for the sample companies. Results showed the mean of ROE (Table 6.1) increased from 14.43 in 2003 to 21.73 in 2003. The t-test (Table 6.3) reported the increase as significant at 5%. Similarly, the mean of ROA (Table 6.1) also reported an increase from 4.58 in 2003 to 7.38 in 2007. Results of the t-test in Table 6.3 also showed an increase as significant at 5%. Furthermore, descriptive statistics in Table 6.1 reported Tobin's Q for 2003 and 2007 was 0.99 and 1.26 respectively which was also reported in a t-test as a significant increase at 5% (Table 6.3).

6.6.2 Leadership Structure and Firm Performance

The relationships predicted in the results of the statistical analysis from Spearman's correlation and analysis of variance provided evidence to support the relationship between separate leadership structure and firm performance. Results reported a significant relationship between separate leadership structures and the accounting-based measure ROE. They did not suggest any relationship between separate leadership and firm performance for ROA or Tobin's Q, for Spearman's correlation or Analysis of Variance. Based on the results, we can conclude that separation of the position of chairman and CEO resulted in increased performance for listed companies in Sri Lanka, which supports the hypothesis (H1), which states that separate leadership structure is positively associated with firm performance.

6.6.3 Board Composition and Firm Performance

Board composition reported in the descriptive statistics suggests that companies complying with the code of best practice on corporate governance increased from 2003 to 2007 and the t-test confirmed that the mean difference was statistically significant. The analysis of variance reported board composition was significantly related to firm performance. Boards composed of a majority of non-executive directors were positively related to ROE, ROA and Tobin's Q, suggesting that board composition is significantly related to firm performance. Statistical results provided evidence to support the hypothesis (H2), which states that the boards composed of a majority of non-executive directors' were positively associated with firm performance among the listed companies in Sri Lanka.

6.6.4 Board Committees and Firm Performance

Analysis of the descriptive statistics indicated that the number of companies employing board committees increased from 2003 to 2007. The t-test also reported the increase as significant. Correlation analysis reported that board committees were significantly associated with ROE for 2003. The analysis of variance also reported the board committees were significantly related to ROE, as well as Tobin's Q, in 2007. Therefore, results provide evidence to support the hypothesis (H3), that board committee structures composed of audit, remuneration and nomination committees are positively associated with firm performance.

6.6.5 Corporate Reporting and Firm Performance

Analysis of descriptive statistics of corporate reporting practices indicated that CSR practices of listed companies have increased from 2003 to 2007. The t-test confirmed that these results were significant. Correlation analysis indicated that CSR reporting was significantly and positively correlated to ROE in 2003. The analysis of variance also confirmed that ROE, as well as ROA, were significantly related to CSR reporting in 2003. Furthermore, results of correlation analysis report CGI and CSR reporting were significantly and positively correlated. The analysis of variance also reported a relationship between CSR reporting and CGI and performance based on ROA in 2003.

However, in 2007, CSR reporting was not positively associated with higher firm performance. Therefore the null hypothesis was not rejected. This will be further investigated in the next chapter supported by empirical evidence.

6.7 Conclusion

The above statistical results provided evidence to support the hypotheses put forward in Chapter 4. Results of the descriptive statistics, t-tests, correlations and analysis of variance have been used to analyse and compare the results for the sample selected from the top 50 listed companies in Sri Lanka for 2003 and 2007. Corporate governance characteristics and the firm performance of the sample were explained in the chapter through descriptive statistics. Results reported the relationship between separate leadership structure, board composition and board committees, CSR reporting and firm performance. Measures of firm performance, ROE, ROA and Tobin's Q, were significantly related to leadership structure, composition, committees and CSR reporting. The implications of the results of the above analysis on corporate governance and firm performance are discussed in the next chapter.

Chapter 7

Discussion and Implications of Results: Corporate Governance Practices and Firm Performance in Sri Lanka

7.1 Introduction

The discussion and implications of the results of the relationship between corporate governance practices and firm performance in Sri Lanka are reported in this chapter. The model presented in the conceptual framework was tested in the previous chapter using the statistical techniques described in Chapter 5, regarding the relationship between board leadership structure, board composition, board committees, CSR reporting and firm performance.

The results of testing the relationships between corporate governance practices and firm performance are presented in the following summary of hypotheses:

- .H1a: Separate leadership structure is positively associated with firm performance
- H1b: A majority of non-executive directors on the board is positively associated with firm performance.
- H1c: Boards committee structures composed of audit, remuneration and/or nomination committees are positively associated with firm performance.
- H1d: Corporate social responsibility reporting practices are positively associated with higher firm performance.

The above hypotheses were analysed and checked for validity of the model.

The structure of the chapter is presented as follows. Section 7.2 discusses the implications of the results for firm performance. Section 7.3 deals with the implications of the results of the relationship between separate leadership structure and firm performance in Sri Lanka. Section 7.4 presents the implications of the results of the relationship between board composition and firm performance in Sri Lanka. Section 7.5 discusses the implications of the results of the relationship between board committees and firm performance. Section 7.6 examines the implication of the results of the relationship between corporate reporting and firm performance. Section 7.7 presents a summary of results and implications of corporate governance and corporate reporting practices in Sri Lanka. Section 7.8 discusses the recommendation for the code of best practice. Finally, Section 7.9 presents the conclusion.

7.2 Firm Performance

This study revealed that corporate governance practices in Sri Lanka show a significant relationship to firm performance measures of ROE and ROA which are accounting-based measures, and Tobin's Q which is a market-based measure. The above firm performance measures report the efficiency of management in increasing profitability and the market value of firms in an unstable political and economic environment such as Sri Lanka. This confirms the agency theory perspective of the relationship between better governance practices and firm performance.

Return on Equity

In this study, the variables that were significantly related to ROE in 2003 for listed companies in Sri Lanka were corporate reporting practices. Both correlation and analysis of variance reported a significant relationship between corporate reporting and ROE. However, the other corporate governance variables such as separate leadership structure, board composition and board committees did not have an impact on ROE in 2003. These results were consistent with a study conducted by Leng (2004). Nevertheless, leadership structure, board composition and board committees were found to be significant in influencing ROE in 2007. Brown and Caylor (2004) also observed that better governance is associated with a higher ROE. Similarly, Wiwattanakantang (2000) reported improvement in corporate profitability is measured by ROE, which is an indicator of complying with corporate governance practices.

Return on Assets

The variables that were significantly related to ROA in 2003 were the combination of separate leadership and board composition, CSR reporting practices, and the combination of CSR and corporate governance index. However, ROA was only significantly related to board composition in 2007. A larger asset base was found to be associated with poorer relative returns. This is attributed to the simple mathematical fact that the larger the denominator, the greater the numerator required to obtain higher profit (Kiel & Nicholson 2003). Kiel and Nicholson also state that if the size of the assets is controlled, revenue is strongly and positively correlated with ROA. Examination of the data in the sample indicated that the total asset base of the companies was larger than the shareholders' funds, hence the results did not show any significant relationship to performance based on ROA.

Tobin's Q

In 2003, the variables that were used to measure corporate governance practices in Sri Lanka did not influence Tobin's Q. However, in 2007 board composition, board committees and independent board structures, which comprise of separate leadership and board composition, and board composition and committees, were significantly related to Tobin's Q. This shows the effect of implementation of corporate governance practices on market value of firms in Sri Lanka. The above relationships also indicate board composition is an important mechanism investors consider in their decisions. This shows that good governance practices were important for investor confidence, because in the emerging markets such as Sri Lanka, growing firms require outside financing for expansion. Therefore it was an incentive to adopt better governance practices to lower the cost of capital among the listed companies. According to Klapper and Love (2004), these growth opportunities would be reflected in the market value of the firm resulting in a positive correlation between corporate governance and Tobin's Q.

CalPERS (2009) Core Principles of Accountable Corporate Governance state that fully accountable corporate governance structures produce best returns to share owners in the long-term. Therefore, a first principle is that good governance practices should focus the board's attention to optimise the company's operating performance through profitability and returns to share owners.

According to Khanchel (2007), good corporate governance should be related to high firm values, because empirical studies report that investors are willing to pay premiums for good governance. He also states that according to other studies, inefficient governance causes additional agency costs, which if markets estimate these additional costs, will result in a drop in stock returns. Alternatively, good governance is a signal of lower agency costs, a signal not incorporated in market prices. Therefore, it is interesting to know if higher firm values are associated with better governance, because the period under review saw a remarkable performance in the Colombo Stock Market, which was resilient to political and economic situation in the country.

7.3 Leadership Structure and Firm Performance

The board leadership structure is an important characteristic of corporate governance in Sri Lanka. The results of the relationship between separate leadership structure and firm performance, reported in Chapter 6 are discussed in the following section in, relation to the proposed model (Figure 4.2) in chapter 4. Separate leadership structure was tested against both accounting-based measures and market-based measures of performance.

Hypothesis H1a: Separate leadership structure is positively associated with firm performance. The hypothesis that separate leadership structure was related to firm performance was accepted. Results of Spearman's correlation analysis for association were presented in Table 6.4, and analysis of variance in Table 6.5 reported a significant level of 5% for ROE in 2007, supporting hypothesis H1a. This relationship was not significant for ROA and Tobin's Q. However, it can be concluded that a relationship exists between separate leadership structure and firm performance based on ROE. Results indicated that separation of responsibilities at the top promotes better results, because the chairman is accountable to the formulation of strategy and the CEO is accountable to the implementation of the strategy and the day-to-day operation of the firm. Therefore, it can be concluded that higher profitability for firms in Sri Lanka is due to better management, as a result of the separation of the position of CEO and chairman.

Discussion: The above results were supported by prior research on the relationship between separate leadership structure and firm performance. The results were consistent with the study conducted by Rechner and Dalton (1991), which reported that firms with separate leadership structure outperformed firms with combined leadership structure when relying on ROE. Similar results that firms with separate leadership structures are associated with higher accounting returns based on ROE compared to combined roles were reported by Rhodes (2001). Another study conducted by Leng (2004) reported that combined leadership structure was not significant for ROE.

In the current study, ROA was not significantly related to separate leadership structure. However, there is research which reported a significant relationship between combined leadership structure and ROA (Dehaene, De Vuyst & Ooghe 2001). The argument is that the same person acting as chairman and CEO will try to increase their investment in the firm to increase the size of the firm, which indicates that ROA is a better measure of performance for firms with combined leadership structures.

The results about the significance of the relationship between separate leadership structure and firm performance in Sri Lanka based on ROE are supported by agency theory. According to the literature, the relationship between separate leadership and firm performance is grounded on agency theory, which is concerned with aligning the interest of shareholders and managers to maximize the wealth of the company. Therefore, advocates of agency theory argue that the position of CEO and the chairman should be separated, as the combined structure can reduce the effectiveness of monitoring (Finkelstein & D'Aveni 1994). Even though stewardship theorists argue that one person occupying both roles may improve firm performance, as it removes internal and external ambiguity regarding responsibility for firm processes and outcomes (Donaldson 1990; Finkelstein & D'Aven 1994), separate leadership structure in this study is supported by agency theory for maximization of shareholder wealth.

In support of the agency theory, the separation of the two roles has been adopted by companies around the world (Banks 2004). Board reform advocates such as Cadbury, ASX and the Malaysian code of corporate governance also promote the separation of the two most important positions in a firm, which is also embraced by the academic community. In Sri Lanka too, reform activists promoted the separation of the position of CEO and chairman, which is referred to in the first report on the Code of Best Practice on Matters Relating to Financial aspects Corporate Governance in 1997 and Code of Best Practice on Corporate Governance issued by ICASL in 2003, and again in 2008. In 2008 this requirement was made mandatory for all listed companies in Sri Lanka.

The results also revealed an increase in ROE for companies in Sri Lanka for the period under review. ROE is measured in terms of efficiency of management in generating profits from shareholders' investments. Therefore, the main purpose of the corporate governance mechanism is to provide reassurance to shareholders that managers will achieve results which are in the best interest of the shareholders (Shleifer & Vishny 1997). One way in which this can be achieved is through an effectively structured board that ensures the interests of the managers are in line with those of the shareholders. When these two positions are held by the same person, it makes management accountable for a body led by management. Separation of these two roles leads to effectively managing the company and creating greater accountability, resulting in better uses of shareholders' investments to generate earnings in the form of return on equity (Monks & Minow 2004).

The practice of separation of the leadership roles is becoming increasingly common among private firms and its benefits are recognized in the context of Sri Lanka. As the size of the firm increases the number of companies that separate the roles increases. The need for separation is felt when the firm size and the requirement for external finance increase.

However, in Sri Lanka, the reason for decrease in the number of companies adopting separate leadership may be due to some companies moving back to combined leadership, but conforming to the code of best practice of 2003 by appointing a lead director. This practice changed for companies reporting on or after the introduction of the code of best practice on corporate governance in 2008, which stated that the decision to combine the positions should be justified and highlighted in the annual report. Studies by Suryanarayana (2005) reported that over 80% of the top 150 listed companies in India had corporate governance mechanisms with separate leadership structures and Table 6.1 in this study also reported similar results in relation to listed companies in Sri Lanka.

Separation of the leadership structure among listed companies has produced opposite results for accounting based-measures and market-based measures of firm performance. The accounting-based measure of firm performance of ROE suggests better performance with a separate leadership structure, because the separation of the two roles gives the CEO responsibility to run the company, while the market-based measure of firm performance Tobin's Q demonstrates otherwise. Similar results were reported by Haniffa and Hudaib (2006). Their results imply that companies in Sri Lanka have reported better accounting results with a separate leadership structure. However, the results based on market measures were not significant, which is not an ideal situation for an emerging market trying to attract investors. Investors consider investment in better managed companies in their investment decisions, but in this study a separate leadership structure had no effect on the market value of firms.

The effect of separate leadership structure on market value in Sri Lanka is reported through Tobin's Q. However, an insignificant relationship between separate leadership structure and Tobin's Q shows that separate leadership structure had no impact on market value. This may be due to the fact that leadership structure on its own may not have been recognized by the market.

In an environment such as Sri Lanka the separation of the two positions is important. In this environment, the chairman is required to have a strategic sense, with an ability to analyse the risk inherent in the business environment. It is also the chairman's role to determine strategies that would mitigate the risk and increase profitability of firms, not just survival.

According to the conceptual framework in Chapter 4 (Figure 4.2), board leadership is an important characteristic of corporate governance in Sri Lanka. Separation of leadership positions of chairman and CEO, which is associated with agency theory, applies to this study because separation of the roles leads to effective monitoring and management resulting in higher profitability. Analysis of the best performing companies in Sri Lanka reports that the companies have diversified into products and markets. This implies that even in firms operating in unstable economic environments separate leadership structures perform better, due to the ability of the chairman to determine strategies better suited to the environment.

7. 4 Board Composition and Firm Performance

Another important characteristic of corporate governance in Sri Lanka is board composition which was investigated in this study. The results of the relationship between non-executive director representation on the board and firm performance in Sri Lanka reported in Chapter 6, and proposed in the conceptual framework (Figure 4.2), was examined with accounting-based measures and market-based measures.

Hypothesis H1b: A majority of non-executive directors on the board is positively associated with firm performance. The hypothesis that board composition and firm performance were positively related was accepted in this study. The results of the descriptive statistics presented in Table 6.1 reported a significant increase in the number of companies which have implemented a majority of non-executive director representation on boards in Sri Lanka for the periods 2003 and 2007. The results of the t-tests presented in Table 6.2 reported the increase as significant at 5%. The results of the analysis of variance presented in Table 6.6 also reported non-executive director representation on boards as significant for ROE and Tobin's Q at a 5% level of significance and ROA at a 10% level of significance in 2007, indicating a positive relationship between a majority of non-executive director representation and firm performance. The above results suggest that outside directors have a significant impact on firm performance in Sri Lanka. The results indicate that independence of the board is an important indicator of firm performance in relation to efficiency of management in generating profits and market value of firms in Sri Lanka.

Discussion: The above results in relation to board composition and firm performance in Sri Lanka are supported in prior research. A survey conducted in Sri Lanka by KPMG reported over 90% of the respondents had a majority of non-executive directors on the boards, which satisfy the requirements of the CSE (KPMG Sri Lanka 2008), and which was also consistent with the results of the descriptive statistics in Table 6.1, reporting a mean of 95% in 2003 and 97% in 2007. Furthermore, the results in support of this study were also reported by Dehaene and De Vuyst et al. (2001). Their findings reported firms with a majority of non-executive directors had greater ROE. An explanation suggested for this relationship is that remuneration of non-executive directors is more closely linked to the financial performance of the shares than that of the executive directors. Similarly, results of a study conducted by Bonn et al. (2004) also supported the relationship between board independence and firm performance for ROA for Australian firms, suggesting that board independence is an important indicator of board effectiveness. A study conducted by Keil and Nicholson (2003) also supported the above results, in relation to non-executive director representation on the board and Tobin's Q, from the point of view of the stock markets. Similarly, a study conducted by Rosenstein and Wyatt (1990) also reported positive reactions of the market to the appointment of outside directors.

The results of this study can be interpreted in relation to the predominant theory of corporate governance, agency theory, which supports independent board structures. The common aim of this theory is to posit a link between governance mechanisms and firm performance.

The monitoring function of the board to protect the shareholders and management from a conflict of interest is addressed in the agency theory, which suggests that monitoring role be undertaken by independent directors, thus alleviating the agency problem. Therefore, employing directors who are objective and not dependent on the firm for employment, sales or other benefits which would impair their independence, is important for board independence. The results of this study support agency theory which suggests that boards composed of a majority of outside directors are able to monitor the self-interested actions of managers, thereby minimizing agency costs (Fama 1980; Fama & Jensen 1983) and maximizing shareholder wealth.

The results of this study indicate that boards dominated by non-executive directors are significantly related to performance for both accounting-based measures and market-based measures. This implies that the companies that complied with the recommendations of code of best practice on corporate governance in Sri Lanka performed well. The Cadbury Report (1992), Hampel Report (1998) and OECD principles recommended that boards comprised of a majority of non-executive directors. The ASX principles in Australia and the Malaysian code on corporate governance have also incorporated the above principles in their governance practices, because non-executive directors bring independence of mind and judgment on issues of strategy and governance on running the business, and also see themselves as assisting in enhancing the prosperity of the business and play an important part in improving the performance of the business (Cadbury 2002).

The results also imply the effectiveness of boards in Sri Lanka. To be effective, a board must have the right mix of skills and experience and work together as a team, which will encourage diverse and healthy debate in the interest of the investors and the company (Roche 2005). The calibre and number of non-executive directors on the board is also important as their views carry significant weight on the board's decision-making (Cadbury 1992). In Asia, a younger generation tends to come armed with MBAs and are more sensitive to corporate governance issues, and are more skilled in marketing, database management, risk management and corporate finance issues than their predecessors. This may also apply to Sri Lanka. Therefore, a small board with complementary skills, experience and a degree of independence can be a more effective board than just appointing a number of individuals. Also in Sri Lanka the mean size of the board is around six (Table 6.1). An examination of the annual reports shows that they are highly skilled experienced and professionally qualified individuals.

The results also imply that non-executive director representation on boards' results in increased share performance. According to Black and Jang (2006) a major concern on board composition is that firms may choose independent boards to maximize share value or use board composition to signal quality of management (Black, Jang & Kim 2006). However, higher share prices may not imply that boards adopting a majority of outside directors could increase market value. There are other factors that contribute to share value such as economic, political and social factors. In Sri Lanka, even though there is adversity in the economic and political environment, firm performance was resilient to the adversity. It shows the importance of board composition in carrying out corporate strategy in mitigating the risk in the environment in the context of Sri Lanka.

The positive relationship between a majority of non-executive director representation and firm performance is based on agency theory, resulting in accountability to shareholders in this study. The results show that boards' accountability to shareholders has resulted in increased profitability through ROE and ROA, and in higher market value through Tobin's Q. Therefore in Sri Lanka, board composition is considered an important component of board structure in increasing firm performance even during unstable economic conditions.

7.5 Board Committees and Firm Performance

The appointment of board committees is considered an important mechanism of corporate governance in Sri Lanka, which was investigated in this study. The results of the relationship reported in Chapter 6, between board committees composed of audit, remuneration and nomination committees and firm performance, was examined with both accounting-based measures and market-based measures.

Hypothesis H1c: Boards committees composed of audit, remuneration and/or nomination committees are positively associated with firm performance. The hypothesis that the relationship between board committees and firm performance was positive in Sri Lanka was accepted in this study. Descriptive statistics presented in Table 6.1 reported an increase in the number of companies which has appointed board committees between 2003 and 2007. Results of the t-test (Table 6.2) reported an increase significant at 5%. Results of Spearman's correlation (Table 6.4) for association reported a 5% level of significance for ROE in 2003. Analysis of variance (Table 6.7) also reported this relationship as significant at the 5% level for ROE and Tobin's Q in 2007. In summary the results indicated a positive relationship between the presence of board committees and firm performance in Sri Lanka.

Discussion: The above results indicate a significant relationship between board committees and firm performance in Sri Lanka. Even though evidence in support of board committees and firm performance is scarce in prior research, Laing and Weir (1999) reported evidence to support the above relationship. They found that firms which had introduced board committees performed better than those without them. Furthermore, Klein (1998) found evidence in relation to the presence of remuneration committees, which were positively associated with firm performance. In contrast, Petra (2007) in his study on board structures with board committees was not associated with earnings informativeness to the stock market performance. Weir and Laing et al (2002) also reported that boards with audit committees had no effect on firm performance. However, the monitoring function of the boards committees is expected to have a positive influence on firm performance (Laing & Weir 1999).

The significant relationship between board committees and firm performance reported in Sri Lanka can be interpreted to support agency theory. Board committees, whose responsibility is to be accountable to shareholders, typically perform the oversight function of the board. The primary role of the audit, remuneration and nomination committees is to act as independent monitors to alleviate the agency problems (Klein 1998; Rezaee 2009), to maximize the value of the company to shareholders through profitability and to increase the performance of share prices. Agency theory was supported by the Cadbury committee (1992), which recommended separate committees for overseeing the remuneration of executive directors, auditing the financial statements and appointing executive and non-executive directors to the board, because shareholders have greater confidence when there are named committees to address the key responsibilities who disclose their existence to the investors (Davis 2002). These recommendations were adopted by Sarbanes-Oxley of 2002, the New York Stock Exchange, NASDAQ and ASX, and were incorporated in the code of best practice on corporate governance in Sri Lanka, which was adopted in the Colombo Stock Exchange listing rules.

The literature explains that most critical processes and decisions derive from subcommittees rather than boards at large (Daily 1994, 1996; Kesner 1988; Lorsch & MacIver 1989), because they enable directors to cope with the two most important problems they face, the time and the complexity of information (Dalton et al. 1998). The subcommittees are a mechanism recommended for improving corporate governance, by delegating specific tasks of the board to smaller groups, and effectively harnessing the contribution of non-executive directors (Spira & Bender 2004). The establishment of audit, remuneration and nomination committees was considered important in improving corporate governance and firms with them are expected to perform better than firms without them. This leads to more responsible behavior by corporate boards and protects the interests of the shareholder (Harrison 1987).

Evidence in relation to the efficacy of board committees in improving firm performance is mixed. But as a result of their ability to monitor, the presence of these committees is expected to have a positive influence, and firms with them are therefore expected to perform better than firms without them. According to Klein (1998), if effective monitoring leads to higher firm performance, then firm performance will be positively related to a higher proportion of non-executive directors in the audit and remuneration committees.

Even though in prior research, the impact of board committees on firm performance is limited, the results of this study report that ROE and Tobin's Q are significantly related to board committees in Sri Lanka, which supports agency theory and accountability to shareholders. The results imply that even in adverse economic environments, board committees are an important mechanism of corporate governance in Sri Lanka which impacts on firm performance.

7.6 Corporate Social Responsibility Reporting and Firm Performance

In this study, the corporate reporting practice of CSR reporting is considered an important aspect of corporate governance in Sri Lanka. The results of the relationship between CSR reporting practices and firm performance in Sri Lanka were tested against accounting-based measures and market-based measures of performance. The results reported in Chapter 6 are discussed in relation to the proposed framework (Figure 4.6) in the following section.

Hypothesis H1d: Corporate social responsibility reporting is positively associated with higher firm performance. The findings of the analysis of the relationship between corporate reporting practices and firm performance in Sri Lanka reported mixed results for the periods tested. Descriptive statistics presented in Table 6.1 reported an increase in the number of companies reporting on CSR from 2003 to 2007. The results of the t-tests (Table 6.2) reported the above increase significant at the 5% level. The results of Spearman's correlation (Table 6.4) for association reported a significant relationship with ROE at a 5% significance level for CSR reporting in 2003. Analysis of variance (Table 6.8) also reported a significant relationship with ROE at a 10% significance level and ROA at a 5% significance level for 2003. The study also tested the effect of good governance structures (CGI) and CSR reporting on firm performance. Tests reported a significant relationship with ROA at a 10% significance level for 2003. However, the results of CSR, reporting was not significant for firm performance indicators of accounting-based measures or market-based measures for 2007. Therefore the null hypothesis ($H0_d$) was not rejected.

Discussion: The results of the above relationship in the context of Sri Lanka, reported inconclusive results. Even though this relationship was significant in 2003 and not in 2007, descriptive statistics reported a significant increase in the number of companies carrying out CSR activities. Analysis of variance did not report any relationship for accounting-based measures or market-based measures in 2007. These results are supported in the literature review. Similar inconclusive results were reported by McWilliams and Siegel (2000). Meta-analysis conducted by Margolis and Walsh (2001) reported 55% of the firms identified a positive relationship between CSR and firm performance, 22% reported no relationship, 18% reported mixed relationships and 4% reported a negative relationship. Similar results were also reported by Orlitzky et al. (2003). Furthermore, studies conducted by McGuire (1988), Balabanis et al. (1998) and Nelling and Web (2009) did not find any relationship between CSR reporting and stock market performance, which supports the current study. However, the results of this study for 2003 is supported by Waddock and Graves (1997), which reported better financial performance based on ROE and ROA.

It is evident from the results that CSR reporting in Sri Lanka did not have an effect on the market value of firms. Balabanis et al. (1998) indicated that capital markets seem to be indifferent to firms undertaking CSR activities and implied that profitable firms were more inclined to carry out CSR activities. However, the effect of CSR on market value is not evident in Sri Lanka. According to Nelling and Web (2009), the only aspect of CSR that is driven by stock market performance is employee relations, but they do not find any evidence of causality between stock market performance and CSR activities, such as those related to the community, diversity or the environment. They believe that if CSR activities provide benefits to the firm, they will be unrelated to financial performance. There is further support for the insignificant relationship between CSR reporting and stock market performance by McGuire et al. (1988). They state that the previous year's stock returns and accounting-based measures are related to the current year's CSR, but the past year's CSR activities are not related to the current year's financial performance.

Even though the results of this study are inconclusive, the positive relationship between CSR reporting and accounting-based measures of firm performance of ROE and ROA for 2003 is consistent with the theoretical perspective presented in the instrumental stakeholder theory. It suggests that a positive relationship exists between CSR and financial performance (Clarkson 1995; Donaldson & Preston 1995; Freeman 1984), because the satisfaction of various stakeholder groups is instrumental for organisational performance (Donaldson & Preston 1995; Jones 1995), which was also reported by Orlitzky et al. (2003). As a result the practice of corporate social responsibility activities is supported by stakeholder theory (Deegan 2004). An important feature of stakeholder theory is that a firm must be profitable to invest in CSR activities, otherwise prospective stakeholders will not invest in companies they do not have confidence in(Jones & Wicks 1999).

CSR in Sri Lanka can be interpreted in relation to the motivational theory of organizational social response based on Maslow's hierarchy, where lower level needs such as corporate profitability and survival, must be satisfied before focusing on CSR of the firm (Tuzzolino & Armandi 1981). On the other hand, Nelling and Webb (2009) point to academic research on the causal relationship between CSR and financial performance that is referred to as a "virtuous circle" in which doing good socially leads to doing well financially and firms which exhibit superior financial performance devote more resources to socially responsible activities. This implies that in order to undertake CSR initiatives, firms must be profitable. This is reflected in the reporting of the top 50 listed companies, which shows that over 78% of them have undertaken CSR activities in 2007.

CSR reporting and the corporate governance index reported a significant relationship with ROA in 2003. However, a higher level of governance practices of firms in Sri Lanka in 2007 does not explain the relationship between corporate reporting practices and firm performance. Results of a study conducted by Arora and Dharwadkar (2011) states agency theory predictions of tighter monitoring leads to decline in positive CSR.

On the other hand, one of the prominent arguments for how CSR activities affect firm performance is the way in which firms satisfy their stakeholders and communicate CSR activities to stakeholders (Rettab, Brik & Mellahi 2008). There is a lack of communication in informing about CSR activities, so CSR efforts are often not known to the stakeholders and subsequently may not have an impact on firm performance. Therefore, in emerging economies such as Sri Lanka, it can be assumed that the stakeholders may not be aware of CSR activities and therefore firms will not be punished or rewarded for their CSR efforts (Rettab, Brik & Mellahi 2008). However, the results of this study imply investors in Sri Lankan listed companies have placed their confidence on corporate governance structures that will provide strategies to mitigate the risk in the environment from political and economic disruptions affecting the country and give lesser importance to CSR practices.

In Sri Lanka, many firms invest in CSR activities that concentrate on developing the communities in which they operate, because they provide a greater potential for the economic development of the country. In this study, relationships are reported for the current year's CSR and the current year's profitability. But previous research shows that the current year's CSR will relate to past years' profitability (McGuire, Sundgren & Schneeweis 1988). Therefore, the current year's CSR efforts will have no effect on the current year's stock market performance.

OECD principles (1999) also emphasized the importance of reporting to other stakeholders and achieving social and economic sustainability. Similarly, WBCSD (1999) addressed the importance of CSR commitment by businesses for economic development. In the rapidly changing and more international world, boards need to be more outward looking and concentrate on a whole range of external factors affecting the enterprise. They are increasingly expected to take into account and report on issues such as their impact on the environment and communities in which they operate (Cadbury 2002). According to CalPERS (2009), environmental, social and corporate governance issues can affect the performance of investment portfolios because shareholders can be instrumental in encouraging good corporate citizenship.

In 2007, CSR reporting was not related to firm performance. Therefore it does not support stakeholder theory. An increase in the number of firms reporting on CSR activities since 2003 may have been due to a large number of companies taking up CSR activities after the 2004 tsunami. This was also reported in a study conducted by International-Alert (2005). They considered that the majority of companies in Sri Lanka engaged in CSR because they genuinely contributed to the betterment of the society, and some were involved in philanthropic activities because they reflected the image of the firms thereby increasing the value of the firm.

7.7 Summary of Results and Implications of Corporate Governance Practices in Sri Lanka

The summary of the results of the relationship between corporate governance practices and firm performance in Sri Lanka are as follows.

1) Results of the relationship between corporate governance and firm performance were not significant in 2003. One of the reasons for the insignificant relationship is because code of best practice on corporate governance was only introduced in March 2003, which was incorporated in the listing rules and compliance was voluntary. Therefore it was too early to see an impact on firm performance and was not reflected in the results.

2) However, this study reported a positive relationship between separate leadership structure and firm performance in Sri Lanka for 2007. The companies that adopted the separation of the roles of CEO and chairman reported higher profitability measured by ROE. The separation leads to the chairman having the role of monitoring and CEO having the role of formulating and implementing the policies that affect the performance of the firm, which is implied by the significant relationship to ROE. The results support agency theory implying effective monitoring resulting from the separation of the two roles and accountability to shareholders.

3) The relationship between a board composed of a majority of non-executive directors and firm performance was accepted for both accounting-based measures and market-based measures. Board composition, which was significant for ROE and ROA, indicated higher profitability resulting in efficient management of resources by firms in Sri Lanka. This is an important factor that has stimulated investors in their investment decisions and the resultant market value of firms was reported through Tobin's Q. Furthermore, the results indicated that board composition is an important mechanism of corporate governance in Sri Lanka in influencing firm performance. This is supported by agency theory, because board structures composed of a majority of non-executive directors have resulted in effective monitoring. The experience and specialists knowledge contributed by the outside directors is important for firms operating in unstable economic environments.

4) Results in relation to the presence of board committees composed of audit, remuneration and nomination committees, and firm performance were also accepted for both accounting-based measures and market-based measures in this study. The monitoring function of the committees resulted in increased profitability measured by ROE and higher market value for firms indicated by Tobin's Q, implying that investors consider board committees in their investment decisions for companies in Sri Lanka. The results support agency theory because the monitoring functions of the board committees lead to higher performance. As a result, firms in Sri Lanka have considered the importance of implementing board committees as a mechanism for board structure, because effective monitoring has a positive influence on firm performance.

5) Comparative analysis shows that firms in Sri Lanka have adopted effective governance practices, which has resulted in increased firm performance between 2003 and 2007, through implementing the code of best practice on corporate governance introduced in 2003. Analysis of board structures (Table 6.1) imply that boards in Sri Lanka has moved towards recommended board structures.

6) The results of the relationship between CSR reporting and firm performance reported a significant relationship for accounting-based measures of firm performance, ROE and ROA, in 2003, which was consistent with stakeholder theory, suggesting the needs of shareholders cannot be met without satisfying the needs of other stakeholders. Even

though CSR activities increased during the period under review in this study (2003 and 2007), no relationships were reported between CSR and firm performance in 2007.

During the period examined in Sri Lanka, in addition to the instability in the economic and political environment, Sri Lanka was strongly affected by the 2004 tsunami. The boards' strategies in the above circumstances were mainly aimed at survival, maximizing firm profitability and rebuilding the tsunami affected communities. The benefits of CSR activities on firm performance are less emphasized as a result of the 2004 tsunami rebuilding activities. However, even though not reflected in the results, a large number of profitable companies in Sri Lanka were engaged in CSR activities related to developing communities as well as tsunami-struck villages. Increased CSR activities were related to the tsunami in 2004, which implies that CSR was not related to business. As a result CSR activities were not reflected in the market value of firms.

7) The results of this study in Sri Lanka imply that for firms operating in unstable economic and political environments, adoption corporate governance practices of board structures recommended in the code of best practice on corporate governance are important to their performance. This also implies that investors are placing their confidence in the management of the companies despite the political instability in the country.

8) Finally, results also can be interpreted in the context of boards' accountability. Even though the role of boards is to be accountable to shareholders, their position has been made complex due to the legal obligations and social responsibilities placed on them due to the changing business environment. As a result of these diverse expectations, their responsibilities have been extended to other stakeholders through corporate social responsibility activities. Even though the results for 2007 of this study do not support boards' accountability to other stakeholders, the long-term sustainability of a firm depends on its accountability to other stakeholders, which is addressed in the recommendation for the code of best practice (Section 7.8) and the model recommended for future research (Section 8.11).

7.8 Recommendations for Code of Best Practice

Drawn from the above research are some of the recommendations that could enhance performance of companies in Sri Lanka. The relationship between board composition and firm performance showed that having a majority of non-executive directors was significantly related to performance. Therefore, the existing code of best practice on corporate governance is recommended for future use with a modification to the board balance.

This research highlights the importance of the control environment in Sri Lanka. In order to perform better, firms need to have a clear understanding of the risks they face, and manage these risks in a satisfactory manner, by allocating appropriate resources to ensure satisfactory controls are in place. Good corporate governance can avoid risk with an appropriate risk analysis strategy, which will lead to a strong effective control environment through appointment of risk management committees in unstable environments such as that existed in Sri Lanka.

A recommendation to include stakeholder interests is suggested in this section. In the current environment, companies must recognize the obligations placed on them through legal and other obligations to a number of diverse stakeholders other than the shareholders, such as employees, customers, creditors and the community. Accordingly, a company that takes stakeholder interests into consideration is likely to experience indirect economic benefits, such as increased productivity and a better corporate reputation.

As a result of the above recommendations, the corporate governance code should include following:

a. .The number of non-executive directors should be at least fifty percent of the total number of directors, not one third as stated in the code.
b. Appointment of non-executive directors to the board must be from a register kept by a body such as the institute of directors.
c. Include a risk management committee.
d. Recognize the various stakeholders relevant to the business that will add value to the organization, and,

i. Consider aligning the CSR strategy with the objectives of the firm.
ii. Define the CSR policies that determine the long-term value of the firm and supervise their implementation.
iii. Communicate the CSR efforts by the firm.
iv. Disclose the CSR efforts by the firm.
v. Conduct and audit of CSR reporting

It is expected that these recommendations to the code will have an impact on firm performance in relation to corporate governance practices in Sri Lanka.

7.9 Conclusion

The implications of the results of the relationship between corporate governance practices and firm performance of listed companies in Sri Lanka were discussed in this current chapter. The relationships in the hypotheses, which were tested for statistical significance, were discussed in relation to the theory, literature and context of the study. Results revealed companies that implemented governance structures recommended in the voluntary code of best practice on corporate governance performed better. Higher performance of companies in Sri Lanka was as a result of better monitoring. The relationship between CSR reporting and firm performance showed mixed results. Only the accounting-based measures were positively related to CSR for 2003. Inclusion of CSR reporting did not show any impact on market value. However, as a result of the importance of stakeholder interests in developing countries such as Sri Lanka, the inclusion of stakeholders' interests was suggested in the recommended code of best practice. A summary of the findings and conclusions will be discussed in the next chapter.

Chapter 8
Summary, Findings and Conclusions

8.1 Introduction

This chapter commences with a discussion of the economic and political environment in which firms perform in Sri Lanka. It also discusses the strategies firms have used to counteract the adverse effects of volatile economic and political environment, which have resulted in the resilience of the economy. Findings of the study are based on various theoretical perspectives and empirical literature on corporate governance practices of both developed and developing countries. Furthermore, this chapter provides a summary of the conclusions drawn from the determinants of firm performance. It also discusses the relationship of corporate governance practices on firm performance to determine if good corporate governance practices in Sri Lanka resulted in accountability to shareholders and other stakeholders through firm performance. Finally, recommendations for the code of best practice and the proposed conceptual framework for future research are summarized.

The structure of the chapter is organised as follows. Section 8.2 provides an overview of the research question and Section 8.3 provides a summary of how the objectives of the study were addressed. Section 8.4 presents the conclusions of the determinants of firm performance and Section 8.5 presents the findings of the study. Section 8.6 discusses the summary of the methodology and conceptual framework. Section 8.7 provides a discussion on the implications of the study. Section 8.8 discusses the limitations of the study and Section 8.9 presents contributions of the study. Section 8.10 provides recommendations for the code of best practice and Section 8.11 discusses future research. Section 8.12 presents the conclusion to the study.

8.2 Overview of the Research Questions

The purpose of this thesis has been to explore the efficacy of corporate governance practices, which affect firm performance resulting in accountability to shareholders and other stakeholders through appropriate corporate reporting practices, which in turn enhance the value of the firms of listed companies in Sri Lanka, during a period effected by economic and political adversities.

Sri Lankas' reliance on local and foreign investment and international trade to mobilise the economy, good corporate governance practices were essential to build investor confidence to attract capital and expand trade. Successfully attracting investment both local and foreign provides a stimulus to the economy, which results in increased productivity and growth. As a result, regulatory reforms in corporate governance were developed in Sri Lanka, through the introduction of code of best practice in 2003.

Therefore this study used a comparative analysis to investigate the extent to which corporate governance practices were adopted in Sri Lanka between 2003 and 2007. Significant relationships between corporate governance practices of separate leadership structure, a majority of non-executive directors and board committees, and firm performance were reported in this study in 2007. The growth in the economy, despite the adverse conditions, is partly due to good governance practices adopted by firms in Sri Lanka.

The economy of Sri Lanka grew by an impressive 6.8% in 2007, in the midst of a number of serious challenges, including rising international oil prices, adverse weather conditions and an unfavourable security situation. The economy's resilience to these adverse conditions was reflected in the growth in the service, industrial and agricultural sectors.

Survival strategies of the corporate sector to maintain a healthy bottom line amidst the economic and political adversities were extremely important to the economy of Sri Lanka. Organizations were undertaking strategies to mitigate risks by diversification into new products and new markets and undertaking emergency reassessments of the short-term goals in the backdrop of a worsening country scenario. Most high performing companies have ventured into new businesses and to offshore destinations. One of the factors for the high performance of companies that operate in this highly volatile environment is their diversification. Furthermore, stock market performance showed share prices in Sri Lanka were also driven by speculative activities, but good governance practices in Sri Lanka have resulted in accountability to shareholders.

In this study CSR did not have a strong impact on firm performance. Therefore a long-term strategy that is recommended to be adopted by the high performing firms in Sri Lanka is to engage in CSR activities for long-term sustainability, which means "corporate governance has evolved from its role of agency costs to creating long-term shareholder value to increasing value of all stakeholders" (Rezaee 2009).

8.3 Summary of the Objectives of this Study

The objectives of the study were the following.

1. To examine the development of corporate governance practices in the context of the Sri Lankan business environment.
2. To investigate the extent to which the companies have adopted corporate governance practices.
3. To determine through a comparative analysis the changes in corporate governance practices between its introduction in 2003 and the time of the study in 2007;
4. To analyse the board structures of the listed companies.
5. To examine corporate reporting practices and the extent of corporate social reporting disclosures among the listed companies.
6. To determine the relationships between corporate governance practices such as board leadership structure, composition and committees, and CSR reporting on firm performance.
7. To recommend a corporate governance model with an emphasis on corporate governance practices, including board structure and reporting, that results in accountability to all stakeholders.

The following summary explains how objectives in this study were addressed.

The development of corporate governance practices in the context of the Sri Lankan business environment was addressed in Chapter 3. The economic and political environment of Sri Lanka was affected by three decades of ethnic war, which ended in 2009. However, the economy of Sri Lanka did not collapse during the war, but showed a steady growth rate despite the volatility of the environment. During the period investigated, the Colombo Stock Market reported record performance despite the volatile economic conditions. One reason may have been the introduction of regulatory reforms in corporate law and corporate governance designed to promote external investments. A voluntary code of best practice on corporate governance was established in 2003. This code addressed the separation of the position of CEO and chairman, representation of non-executive directors on the board and the establishment of board committees consisting of audit, remuneration and nomination. This code was made mandatory for all the companies listed in the Colombo Stock Exchange in 2008.

Investigation of the extent to which the companies have adopted corporate governance practices show, how these were established in Sri Lanka through voluntary and mandatory mechanisms involving a code of best practice which was described in Chapter 3. Comparative analysis of corporate governance practices showed the extent to which the firms have adopted the code of best practice between 2003 and 2007. Descriptive statistics in Table 6.1 showed the extent to which companies adopted corporate governance practices in Sri Lanka. In 2003, 84% of the firms in the sample had adopted separation of the position of CEO and chairman, whereas in 2007 there were 81%. The proportion of firms which had complied with non-executive director representation on the boards in 2003 was 95%; this increased to 97% in 2007. In 2003, 59% of firms had board committees; this increased to 78% in 2007. A comparison of data from annual reports for 2003 and 2007 shows that governance practices increased from 2003 to 2007.

This study reported an analysis of the board structures of listed companies in Sri Lanka. Investigation of the governance structures recommended by the code of best practice on corporate governance in Sri Lanka shows that board structures should comprise of separation of the position of CEO and chairman, have a majority of non-executive director representation on the board and have board committees comprising of audit, remuneration and nomination committees. Board structures were investigated in this study through descriptive statistics, which showed that 81% of the firms had separate leadership, 97% consisted of a majority of non-executive directors on the board and 78% had board committees consisting of audit, remuneration and nomination committees in 2007.

This study also examined corporate reporting practices and the extent of corporate social reporting disclosures among the listed companies. Corporate reporting practices in Sri Lanka consisting of mandatory and voluntary reporting were addressed in Chapter 3. Financial reporting is considered mandatory, through the *Sri Lankan Accounting and Auditing Standard Act No. 5 1995*. However, CSR reporting is voluntary. This study investigated CSR disclosures by the listed firms. The descriptive statistics showed 51% of firms in 2003 and 78% in 2007, disclosed CSR activities. T-tests showed that the difference between the years was significant. The conclusion was that CSR reporting had increased over the period.

In order to determine the relationships between corporate governance practices such as board leadership structure, composition and committees, and CSR reporting on firm performance in Sri Lanka, this study employed Spearman's correlation and analysis of variance. Analysis of variance showed that as a result of the introduction of code of best practice, board structures and firm performance reported a significant relationship in 2007 compared to 2003. Both accounting-based measures of ROE and ROA and market-based measures of Tobin's Q were used as performance measures. The results did not find any relationships between board structures and firm performance in 2003. However, in 2007, a significant relationship between ROE was found with separate leadership structure, majority of non-executive directors and board committees. Boards with a majority of non-executive directors and board committees were also positively related to ROA and Tobin's Q.

In this study, CSR reporting showed a significant relationship with ROE in 2003, indicating that profitable firms were more inclined to carry out CSR activities. In

2007, CSR had no impact on firm performance even though the number of firms carrying out CSR related activities had increased. This was due to the political and economic situation of the country and the impact of the 2004 tsunami that affected Sri Lanka. As a result, CSR activities by the firms were charitable or philanthropic and more related to rebuilding activities due to the Tsunami 2004. A large scale natural disaster can overshadow CSR related activities for a number of years, since CSR activities must be related to business to have an impact on firm performance.

Finally, this study recommends a corporate governance model with an emphasis on corporate governance practices, including board structure and reporting that result in accountability to all stakeholders. The results of this study discussed in Chapter 6, imply that the board leadership structure is an important determinant of firm performance in Sri Lanka. However, for corporate reporting practices of CSR to have an impact on firm performance in a developing country such as Sri Lanka, the code of best practice on corporate governance should include stakeholder interests. This could result in the corporate strategy of the boards incorporating CSR strategies that are directed at developing rural communities and related to business. This is considered to have an impact on the long-term sustainability of the firm resulting in increased performance. The model recommendations are explained in Section 8.11 below.

8.4 Conclusions of the Determinants of Firm Performance

The results of this study and the literature report that good corporate governance is an important factor in determining firm performance. Many business failures are due to the board's inability to address the overall company performance in an effective and consistent manner. The reason for this lies in the structure of the board, particularly in relation to the structure of the decision making process which needs to be reformed to enable companies to focus on sustaining high performance in the face of a rapidly changing environment (Cutting & Kouzmin 2000). Therefore, governance structures must be designed to improve the quality of monitoring of board decisions (Laing & Weir 1999). It can also be argued that firms which have implemented effective governance practices consisting of the board structures recommended in the code of best practice in Sri Lanka are likely to have also adopted strategies that will result in long-term sustainability of the firms. These strategies should also include engaging in CSR activities, which will consequently result in socially responsible business (SRB) in Sri Lanka, which will have an impact on market value of firms.

Furthermore, studies have reported that for governance practices to have a positive effect on firms' market value they must satisfy two conditions. Firstly, good governance practices must result in an increase in shareholders return; and secondly, the stock markets must be sufficiently efficient so that, the shares prices reflects the fundamental values, which is calculated as the sum of future income generated by the assets, discounted to the present value (Bai et al. 2004). These conditions may be satisfied in mature markets rather than in an emerging market such as Sri Lanka. Consequently, in Sri Lanka, share prices in the stock market are also driven by speculative activities. Investment in the stock market is dominated by local investors accounting for two thirds of the turnover, which explains the above. Interestingly, these investors seems to have factored into their investment decisions the uncertainties in the economy related to the ongoing conflict (Institute of Policy Studies 2007), which ended in May 2009.

Analysis of governance structures in Figure 6.1 shows companies in the sample have moved towards the governance mechanisms recommended by the voluntary code of best practices on corporate governance in Sri Lanka issued in 2003. The findings of this study report that adoption of these governance structures has increased shareholder returns resulting in increased market value of firms, hence firm performance. Furthermore, firm performance indicators based on ROE, ROA and Tobin's Q reported in Figure 6.1 show that firm performance in Sri Lanka has increased even under the adverse conditions. The following section reports the conclusions for the results of the previous chapter and for the hypotheses presented in Chapter 4.

8.4.1 Relationship of Separate Leadership Structure and Firm Performance of Listed Companies in Sri Lanka.

Separate leadership structure is an important corporate governance variable reported to increase firm performance in Sri Lanka. Analysis of the results shows that the relationship between separate leadership structure and firm performance was significant (H1a) for ROE.

Separate leadership structure in this study is supported by agency theory, which stresses the importance of the boards' accountability to shareholders. Findings report the same person holding both roles will reduce the effectiveness of board monitoring (Finkelstein & D'Aveni 1994), hence affecting firm performance. The Cadbury committee recommendation (Cadbury 1992) to separate the leadership position was adopted by over 80% of the listed companies in Sri Lanka, because one person with too much power within the decision-making process was regarded as an undesirable practice. A similar practice was recommended in the code of best practice in Sri Lanka. Furthermore companies that wish to list in the Colombo Stock Exchange must comply with the code of best practice on corporate governance. Hence, companies must report if the role of the chairman and CEO is separated. Otherwise they must report reasons for not complying with the recommended practice.

Even though both roles require leadership skills, the skills and abilities required by the two roles differ. The chairman needs to have a strategic sense and ability to analyse the highly competitive business environment the firm operates in and to stand back from day-to-day operations. In contrast, the CEO is engaged in the implementation of the board strategy and day-to-day running of the company. One person can be excellent in doing both jobs, but separation is a better strategy, as most people are better at doing one than the other, and because separation of the roles can result in increased profitability as a result of spreading the workload, which can bring out the best in both (Cadbury 2002).

Prior empirical evidence reported that separate leadership structure consistently outperformed combined structure with respect to ROE (Rechner & Dalton 1991; Rhoades, Rechner & Sundaramurthy 2001). Whereas, Brickley et al. (1997) found no systematic relationship between combined structure and accounting or market-based performance measures. Furthermore, they found that changes to leadership structure had no effect on share prices. Balinga et al. (1996) indicated that the market does not respond to changes in duality status. Bai et al. (2004) reported that combined leadership negatively affects Tobin's Q. Prior studies do not favour one leadership style over the other. The results relating to board leadership are mixed for the current study, and are consistent with prior research. It does not find any conclusive evidence relating to one school of thought. Therefore, based on the empirical evidence and the results of this study, we can conclude that separate leadership has resulted in efficient management of firms reported through higher profitability for listed companies in Sri Lanka.

However, there are no recommended optimal universal board structures. It can be concluded that companies should select the structures that are suitable to their organizational characters, business environment (Lam & Lee 2008) and size of the business (Kiel & Nicholson 2003). It can be seen from this study and empirical research that separate leadership structure is more often adopted by large companies because of the requirement for external finance. Furthermore, due to the importance in contributing to increased accountability and to ensure the shareholders interests are given due weight, separate leadership structure applies mainly to listed companies in Sri Lanka.

Based on the findings it can be concluded that separation of the two positions is a structure that will provide benefits to the firms operating in unstable environments such as the one that existed in Sri Lanka.

8.4.2 Relationship of Board Composition and Firm Performance of Listed Companies in Sri Lanka

Board composition is a variable of corporate governance that reported to have a substantial effect on firm performance in Sri Lanka. The relationship between a majority of non-executive directors and firm performance of listed companies in Sri Lanka was significantly related to (H1b) accounting measures of ROE and ROA and the market-based measure of Tobin's Q in this study.

The board composition in this study was supported by agency theory, resulting in accountability to shareholders. Because adequate monitoring by a greater proportion of outside directors protects the interest of the shareholders from the self interested actions of the managers (Fama & Jensen 1983), minimizes agency costs and increases shareholder wealth. In addition, this study was also supported by resource dependency theory because non-executive directors bring experience and diversity of skills, which is an important aspect for firms operating in an uncertain political and economic environment as in Sri Lanka.

Increased focus on corporate governance issues around the world, has stimulated companies to focus more on boards with a majority of outside directors, because non-executive directors are a mechanism employed to perform the monitoring function of the board and increase board independence. Their presence is also considered to improve the effectiveness of internal control. Therefore boards comprising of independent outside directors are a primary mechanism to ensure boards' accountability to shareholders, which was reported in the findings of this study.

The importance of the proportion and the role of non-executive directors on the board was emphasized by the Cadbury committee recommendations, Hampel report 1998 and OECD principles 2004. These recommendations were incorporated in the code of best practice on corporate governance in Sri Lanka. The companies which had adopted the practice of non-executive director representation on boards reported a significant relationship with firm performance.

As reported above, the results on board composition and firm performance in Sri Lanka suggested a strong relationship for both accounting-based measures and market-based measures, which was consistent with prior research. According to Dehaene et al. (2001) and Baysinger and Butler (1985), the accounting-based measure of ROE was significantly related to the number of external directors. Similarly, findings by Bonn et al. (2004) also reported a positive relationship with the number of outside directors for ROA. Board composition was also considered important from the point of view of share price performance. Findings of the study by Keil and Nicholson (2003) and Lefort and Urzua (2008) confirmed a positive relationship between board composition and market-based performance measures of Tobin's Q. Adopting recommended governance structures recommended can result in effective boards leading to higher performance, thus better management and investor confidence. Therefore, it can be concluded that the presence of outside directors on the board is an important determinant of firm performance for companies operating in unstable economic and political environments in Sri Lanka as suggested by the present study.

8.4.3 Relationship of boards committees and firm performance of listed companies in Sri Lanka

Board committees are another important variable of corporate governance in Sri Lanka that reported a significant effect on firm performance. The relationship of board committees and firm performance of listed companies in Sri Lanka also reported a significant relationship (H1c) with accounting-based measures of ROE and market-based measures of Tobin's Q.

Board committees should be accountable to shareholders through the monitoring mechanism which is designed to protect the interest of shareholders (Jensen & Meckling 1976). This is supported by the agency theory mentioned earlier in this study. Agency theory was also supported by the governance reformists such as Cadbury (1992), who highlighted the importance of strengthening the board's accountability by appointing board committees comprising of audit, remuneration and nomination committees for overseeing the financial reporting process, and improving the procedure through which outside directors are selected and compensated. These recommendations were incorporated in the code of best practice on corporate governance in Sri Lanka. Consequently, companies which adopted the practice of appointing board committees were significantly related to firm performance.

Even though there is limited evidence in support of the relationship between board committees and firm performance, Laing and Weir (1999) found audit and remuneration committees had a positive impact on firm performance. Whereas studies conducted by Klein (1998), reported board monitoring committees had no effect on firm performance and Weir and Laing (2001) did not find remuneration committees had an effect on firm performance. However, companies with such committees are expected to perform better than companies without them. Therefore in conclusion, the board committee structures which companies in Sri Lanka have adopted and that were recommended in the code of best practice on corporate governance in Sri Lanka, contributed significantly to firm performance, through increased profitability and market value, even during adverse economic and political conditions.

8.4.4 Relationship of Corporate Reporting and Firm Performance of Listed Companies in Sri Lanka

Corporate reporting practices of CSR were the final variable considered in this study to have an effect on firm performance in Sri Lanka. The relationship between CSR reporting and firm performance of listed companies in Sri Lanka suggested mixed results, since the accounting-based measures of ROE and ROA were related to firm performance in 2003, but no relationship was found to exist in 2007 for accounting-based or market-based measures of firm performance variables. Therefore, in this study the null hypothesis ($H0_d$) was not rejected for CSR and firm performance.

Even though results in relation to CSR and firm performance were inconclusive, the results of this study for 2003 were consistent with stakeholder theory. Furthermore, results were also related to the instrumental stakeholder theory, because firm performance based on profitability measures of ROE and ROA in Sri Lanka suggested a positive relationship between CSR and financial performance resulting in organizational performance in 2003.

In relation to CSR reporting and firm performance, WBCSD (1999) and OECD (1999) principles addressed the issue of firms' impact on the environment and communities, thus extending the boards' responsibility to other stakeholders.

Even though, the results of the relationship between CSR and firm performance in Sri Lanka reported mixed results for 2003 and 2007, CSR reporting by companies in the sample increased significantly from 2003 to 2007. A fundamental reason for the increase, as reported in this study, was the tsunami devastation in 2004, which resulted in acts of philanthropy by many firms in Sri Lanka (International-Alert 2005). These results were supported by prior research (McWilliams & Siegel 2000). Waddock and Greaves (1997) and Margolis and Walsh (2001) also reported a positive impact of CSR on financial performance. But, insignificant relationships were reported for CSR and capital market performance in a number of studies (Balabanis, Philips & Lyall 1998; McGuire, Sundgren & Schneeweis 1988; Nelling & Webb 2009). In Sri Lanka, CSR did not have an impact on the market value of firms. However, profitable firms were more inclined to carryout CSR activities. CSR activities in Sri Lanka were mainly on community issues. According to Bird et al. (2007), markets do not seem to value philanthropic activities, nor do they seem too concerned when company policies publicly conflict with community issues. Based on the economic and political situation of Sri Lanka in the period under review, it is not possible to determine the value of CSR activities in relation to firm performance.

For CSR to have a response in developing countries such as Sri Lanka, attention must be directed to prior satisfaction of lower level needs such as corporate profitability and survival (Tuzzolino & Armandi 1981). CSR is also not an established topic in emerging economies such as Sri Lanka. Therefore not much attention has been given through the media to firms engaged in CSR activities, which generates public goodwill and ultimately enhances corporate reputations (Rettab, Brik & Mellahi 2008). Lack of visibility of CSR activities in the emerging markets may be a reason for not having an impact on corporate reputations. For CSR to have an impact on corporate reputation, firms must communicate the strategy to key stakeholders and the media which is not always possible for firms operating in emerging markets such as Sri Lanka (Rettab, Brik & Mellahi 2008). During the period under review of this study, Sri Lanka was facing political uncertainty. Therefore, the emphasis was on economic performance and survival of firms' with less importance given to CSR performance. Furthermore, CSR during this period was mainly for rebuilding the tsunami devastated villages and was not related to business.

8.5 Findings

Comparative analysis reported the extent to which firms in Sri Lanka has adopted the governance structures recommended by the code of best practice between 2003 and 2007, which was reported through descriptive statistics. Analysis of variance reported a significant relationship between board structures and firm performance in 2007 in comparison to 2003. Central to corporate governance, is to serve the interests of shareholders through implementing independent board structures for accountability of the board, which shows that effective governance practices should comprise of separation of the Chairman and CEO, non-executive director representation on the board and board sub-committees. Good corporate governance practices also ensure accountability through providing reliable and quality financial information, which enhances the integrity and efficiency of the capital markets leading to investor confidence. Therefore, it is apparent that the firms in Sri Lanka have implemented the independent board structures to gain investor confidence as a result of the need for external capital.

Results of the study reported a distinct relationship between independent board structures and firm performance, which supports agency theory. Furthermore, ROE and Tobin's Q are performance measures significantly related to board structures in Sri Lanka. Black et al. (2006) reported evidence from previous studies that a better governed firm is more profitable and investors value the same earnings or the same dividends for better governed firms. In effect, firms that are better governed appear to enjoy a lower cost of capital. Hence, the study reports accountability to shareholders enhances performance and contributes significantly to the market value of firms. Thus, the findings provide evidence that good governance practices challenges firm performance, even in a country which was plagued by almost three decades of internal war, leading to an unfavourable investor environment, which has crippled economic growth for decades. The effects of corporate governance practices are evident in the market value of firms in Sri Lanka.

Even though firms in Sri Lanka operated in a highly volatile environment, good governance practices have lead firms to adopt strategies that mitigate adversities in the political and economic environment. Examination of these strategies indicate the factors that have led to higher profitability among the Sri Lankan companies, includes diversification of products and markets, as well as moving to overseas destinations.

In addition to governance structures, descriptive statistics also reported a significant increase in the number of firms undertaking CSR activities in 2007 compared to 2003. Approximately 75% of the top fifty listed companies in Sri Lanka disclosed their CSR initiatives in their annual reports in 2007. According to Fernando (2007) this significant increase in CSR was due to the activities related to the tsunami of 2004. Analysis of the results reported mixed results in relation to CSR and firm performance. It suggested a positive relationship in 2003, indicating that firm profitability was related to CSR activities. However, CSR initiatives among the listed companies have not had an impact on firm performance in 2007. According to the survey conducted by International Alert in 2005, 73.2% of companies had a CSR policy and 17% of them had a formal written policy, and 84.1% of the companies were engaged in CSR because they genuinely contributed to the betterment of the society (Fernando 2007).

Empirical research did not find much evidence to support the impact of CSR on the market value of firms. But the insignificant relationship between CSR and firm performance in Sri Lanka is due to a number of reasons. Firstly, CSR activities were considered to be philanthropy by most firms because Sri Lanka has a long history of charitable giving, but only a few companies had a strategy or policy for CSR (International-Alert 2005) during the period studied. Secondly, it depended on how the firm communicates and reports their CSR practices in the media (Rettab, Brik & Mellahi 2008). Therefore, a lack of visibility of CSR may not have an impact on corporate reputation. Finally, it may not have been possible to prove the impact of CSR activities on market value, due to the volatile economic and political situation in Sri Lanka and the 2004 tsunami.

It can be seen that even in a highly volatile economic and political environment, good governance practices resulted in increased firm performance. But it is not possible to serve shareholders without serving other stakeholders in the long term. Therefore, boards in Sri Lanka need to take care of both shareholders and other stakeholders for the long-term survival of the firm. Even though CSR practices have increased in the period under review, the corporate strategy of firms needs to link philanthropic and charitable CSR activities to socially responsible business (SRB), with the aim of serving the socio-economically disadvantaged communities for the economic development of the country.

Findings of this study also reported an important aspect of board balance. The range of experience and attributes that outside directors bring to the board is linked to the resource dependency theory. This theory sees the need for larger organizations to have a greater link with other organizations. Therefore, a proposition in support of resource dependency theory is the external linkage due to increasing environmental uncertainty, which predicts a relationship between uncertainty or environmental dependency and board composition as measured by the proportion of outside directors and the size of the board (Hillman, Cannella Jr & Paetzols 2000). This relationship was confirmed by previous researchers Pfeffer and Salancik (1978) and Gales and Kesner (1994), which relates to firm performance and the uncertain environment that existed in Sri Lanka.

This study also shows that the introduction of code of best practice on corporate governance in Sri Lanka in 2003 has resulted in larger companies adopting the recommended corporate governance practices and increase in performance was strongly associated with corporate governance practices. Similar findings were reported by Reddy et al (2010) after the introduction of New Zealand Securities Exchange Guidelines.

Finally, for corporate governance practices to have a full impact on firm performance, strategies of the board should include CSR initiatives that are in the interest of all stakeholders and are relevant to business performance. The findings suggest a new conceptual framework that includes a corporate governance framework in which boards' accountability to all stakeholders incorporates the community development aspect of CSR into the corporate reporting strategy of firms in Sri Lanka. This will be presented in section 8.11.

8.6 Summary of Methodology and Conceptual Framework

8.6.1 Methodology

As discussed in Chapter 5, the relationship between corporate governance practices and firm performance in Sri Lanka was tested with a sample selected from the top 50 listed companies in The LMD 50 for years 2003 and 2007. Data were collected from secondary sources such as annual reports and The Lanka Monthly Digest 50.

The variables used to test the hypotheses were based on governance practices recommended in the code of best practice on corporate governance in Sri Lanka. Firm performance in the study was measured using ROE, ROA and Tobin's Q. The corporate governance practices were measured using separate leadership, board composition, board committees and CSR reporting practices.

SPSS statistical program was used to calculate the descriptive statistics, two-related-sample t-test, Spearman's correlation and analysis of variance for the variables in the framework. Similar methodology was used in previous studies, and was appropriate for the current study due to the sample size and characteristics of the data.

8.6.2 Conceptual Framework

The conceptual framework of the study presented in Chapter 4, was designed to find the relationship of board structure and corporate reporting with firm performance of listed companies in Sri Lanka.

The theoretical framework explained the theoretical perspective of the study based the agency theory, stewardship theory and stakeholder theory in relation to boards' accountability to shareholders and stakeholders. The conceptual framework explained how the board structure and corporate reporting practices of firms in Sri Lanka could impact firm performance.

The conceptual framework presented in Figure 4.2 was the basis for developing the hypotheses for this study. The hypotheses were tested for validity using the methodology presented in Chapter 5. Analysis and discussions of the hypotheses were reported in Chapter 7. The conclusions relating to the hypotheses are reported in the current chapter.

8.7 Implications of Study

In the current environment, firms in Sri Lanka are affected by many external factors. Hence, this research raised the question of to what extent can we measure the impact of the economic and political environment of a country on corporate governance.

In Sri Lanka, the business environment is dominated by the private sector. The findings of this study show that implementing good governance practices increases firm performance. As a result, this study has significant implications for the corporate sector, investors, policy makers, international agencies, government and stakeholders, due to the importance of the corporate success to the economy of the country.

The value of corporate governance research in Sri Lanka depends on its ability to contribute to corporate performance and promote economic development. Findings report that firms operating in highly volatile environments such as Sri Lanka, require good corporate governance practices such as separation of the chairman and CEO, non-executive director representation on the board and establishment of board monitoring committees that would improve firm performance. These good corporate governance practices were promoted by the Cadbury code (1992) for accountability, transparency and effective decision making processes of boards. Consequently, this study was carried out to provide a useful framework for firms in Sri Lanka that are attempting to improve or implement corporate governance structures.

Due to the challenges facing the economy in Sri Lanka, it is necessary to build confidence in investors and other international agencies through reforms in corporate governance, financial reporting and corporate laws. Sri Lanka was also indirectly pressurised by the International Monetary Fund (IMF) and OECD to improve legal, institutional and regulatory framework for better governance to qualify for a debt relief program. As a result, the code of best practice on corporate governance was made mandatory for all listed companies, which was issued jointly by ICASL and SEC in 2007 and the new company’s Act was issued in 2007. The results of this study show the effectiveness of corporate governance in Sri Lanka.

Corporate governance has evolved from its role of reducing agency costs for shareholder wealth maximization, to now creating shareholder value and protecting the interest of all stakeholders. Stakeholders are an important component of this study, because organizations have relationships with many constituents other than the shareholders. Good corporate governance practices are important for accountability to shareholders and other stakeholders. Findings suggest boards’ accountability to shareholders enhances the value of a firm, which supports the agency theory view of a positive relationship between corporate governance structures and firm performance. Accountability to other stakeholders also arises as a result of good governance practices. Particularly, governance structures that consider the interest of stakeholders are significant for corporate success and for socio-economic development.

Shareholders are driven by maximization of value for their share prices and invest in companies which provide them with appropriate returns on their capital in the form of dividends or future cash-flows of the firm or both. Since capital is mobile, investors are free to reallocate their capital if the value is not maximized. As a consequence, investors prefer companies with improved corporate governance practices which provide evidence of higher corporate performance. This contention is supported by prior research, which has reported positive relationships between corporate governance practices and stock market performance. Therefore potential benefits of improved corporate governance structures implied in this study include increased investor confidence and access to new capital through foreign and local investors.

8.8 Limitations of the Study

The scope of the study was limited to the top 50 listed companies in the LMD50. This study selected the top 50 companies listed in the Colombo stock exchange, because the top companies were more likely to have the resources and motivation to take the opportunity to adopt good corporate governance practices prior to their adoption being made mandatory by the stock exchange. Although the sample was small, it represented different sectors of the economy. As a result the sample was representative of companies listed in the Colombo stock exchange. The small size of the sample prohibited in-depth analysis of the relationships between the variables. Therefore, additional statistical analyses such as regression could not be employed. The findings may have been different if a larger sample was included and the study period was extended. If the study had also included a qualitative component in designing the research, it would have provided more comprehensive insight into the boards' accountability to all stakeholders in the context of Sri Lanka.

After the introduction of the mandatory *Code of Best Practice on Corporate Governance* in 2008, the new *Companies' Act, No. o7 of 2007* and a more stable political environment, a larger sample and statistical analyses employing econometrics, could further investigate the corporate governance and firm performance relationships, the effect of CSR on corporate performance, and the boards' accountability to all stakeholders in Sri Lanka.

8.9 Contribution of the Study

The findings highlighted the impact of independent board structures on profitability and market value of firms in unstable environments. This study provides evidence that firms, which have implemented effective corporate governance structures, perform better in such environments.

Prior research on corporate governance and firm performance has never been studied in developed or emerging markets during highly volatile political and economic periods. Sri Lanka is an example of how corporate governance can impact firm performance in these circumstances. This current research contributes to the body of knowledge on corporate governance on how board structures can affect firm performance in volatile environments. Especially in unstable environments such as that experienced in Sri Lanka, investors consider good corporate governance practices as an important factor for firm performance.

The theoretical perspective of this study supports the argument put forward by agency theory, that corporate governance is a mechanism created to monitor the management, minimizes the problems that may be caused due to the principal-agent relationship and ensures maximization of profits for shareholders. Furthermore, according to motivational theory of organizational social response based on Maslow’s hierarchy, lower level needs such as corporate profitability and survival needs to be satisfied prior to focusing on CSR of the firm (Tuzzolino & Armandi 1981). This supports the assertion that companies with strong economic performance are likely to carryout higher levels of social disclosures, which affirms the stakeholder theory. Hence, this study contributes to the literature, in proving that efficient corporate governance practices increases firm performance leading to higher CSR activities by the firms.

This study also contributes the following to the literature: that during large scale natural disasters, CSR activities would have no effect on firm performance, because CSR activities by the firm would be directed towards rebuilding (for example rebuilding tsunami struck villages) and would not be related to business.

8.10 Recommendations for Code of Best Practice

This study proposed that the code of best practice should include the boards to have at least fifty percent of non-executive directors, not one third as stated in the code. It was also proposed to select the directors from a register kept by the institute of directors.

In order to have a clear understanding of the risk, and manage the risks identified in a satisfactory manner, it was proposed to appoint risk management committees.

Lastly, as a result of the importance of accountability to other stakeholders, this study recommended the inclusion of interests of other stakeholders in the code of best practice, which would result in share prices responding to CSR practices of firms in Sri Lanka.

8.11 Recommendations for Future Research

This research has provided some interesting insights, which has influenced our thinking and input to the new model.

Proposed Normative Conceptual Framework for Accountability to all Stakeholders

It can be seen that good governance practices by listed companies in Sri Lanka have resulted in better financial and stock market performance. But CSR practices of the firms did not have an impact on firm performance. Therefore we propose a conceptual framework designed to capture the disadvantaged rural communities in increasing the firm performance through boards' accountability to all stakeholders. The end of the war, the inflow of offshore funds, and the ability to explore and develop the resources within the country are among the positive factors promoting a stable political and economic environment, which is ideal for implementing strategies for the long-term development of the country. The following model shows the importance of accountability to all stakeholders for Sri Lanka.

Stakeholder Model versus Shareholder Model

This study considers accountability as an important concept of corporate governance. Rezaee (2009) describes "corporate governance as the way a company is managed, monitored and held accountable". As discussed previously, corporate governance is a mechanism created to monitor management to minimize problems that may be caused due to the principal-agent relationship and to ensure maximization of profits for shareholders. Therefore, the shareholder model focuses on maximization of profits, because the primary responsibility is to shareholders. According to this model profit is maximised through existing markets.

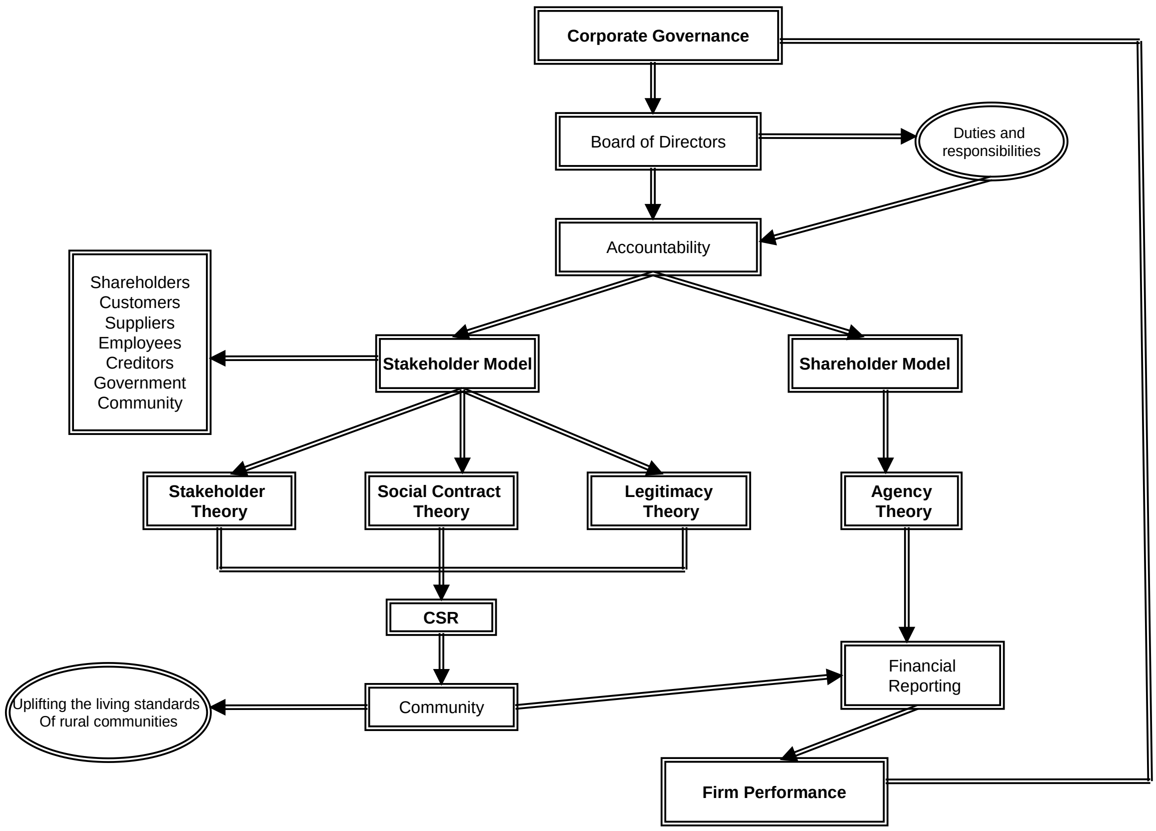
In contrast, according to the stakeholder model, directors' accountability extends to all stakeholders who are directly or indirectly affected by the actions of the firm. As such, stakeholder theory, social contract theory and legitimacy theory all refer to the firms' obligation to society. Key feature of the model in this study is that CSR of the firms that operate in Sri Lanka should focus on developing the communities in which they operate. Three quarters of the population in Sri Lanka live in rural areas and 80% of this rural population is considered poor, because infrastructure required for developing these areas are minimal resulting in low living standards. Therefore, firms and communities can benefit through the development of these communities. The firms are able to gain new markets, increase financial performance and obtain higher market value for the shares, and communities can benefit from economic development.

Empirical research by Spicer (1978), Anderson and Frankle (1980) and Shane and Spicer (1983) produced results consistent with the notion that corporate social responsibility activities impact on financial markets. Adopting corporate social responsibility can improve the value of firms and provide social justice in developing markets to a higher degree than in developed markets, because there is social, economic and cultural chaos in these markets. Reducing these problems can benefit the society as a whole and will improve the value of firms (Banks 2004; Crowther & Lez-Rayman-Bacchus 2004).

Therefore the stakeholder versus shareholder model (Figure 8.1) suggests that CSR initiatives focused on lower income communities can improve the living standards resulting in increased performance of companies in the long term. As a result, the corporate strategy of board needs to incorporate CSR strategies directed at the rural disadvantage communities to create jobs and improve income for socio-economic development.

Figure 8.1

Stakeholders versus Shareholders Model



8.12 Conclusion

This concluding chapter has discussed corporate governance and firm performance in Sri Lanka, which leads to the central argument of the study. Board structure was considered important for effective corporate governance and in improving firm performance in volatile environments. It was found that board structures resulted in accountability to shareholders through firm performance, which was considered important for investors and international lending agencies in the current environment. Board structures also resulted in accountability to other stakeholders through increased CSR reporting practices by the firms in Sri Lanka. However CSR had no effect on firm performance. The study also discussed the appropriateness of the methodology and the conceptual framework. It was suggested that future research should be carried out with a larger sample after the introduction of the mandatory code of best practice in 2008. The recommendation for code of best practice on corporate governance suggested inclusion of stakeholders' interest. Finally, the recommendations for future research proposed a normative conceptual framework and suggested the CSR strategy of firms should be directed at the socio-economic development of the country, which may have an impact on profitability and stock market performance in the long term.

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Appendices

Appendix 1

Descriptive Statistics of Corporate Governance and Firm performance variables

2003		LDS	COMP	NONEX	COMIT	REP	BSIZE	CSIZE	TASS	ROE	ROA	TOBQ	CGOV
N	Valid	37	37	37	37	37	37	37	37	37	37	37	37
	Missing	0	0	0	0	0	0	0	0	0	0	0	0
Mean		.84	.6051	5.05	.59	.51	8.43	3053.32	17930.03	.1443	.0457	.9919	.51
Median		1.00	.5800	4.00	1.00	1.00	9.00	1551.00	5172.00	.14	.0400	.9300	1.00
Mode		1	.50	4	1	1	10	960	4728	0	.04	.99	1
Std. Deviation		.374	.20408	2.415	.498	.507	2.316	4100.529	27351.961	.10963	.04622	.27323	.507
Variance		.140	.042	5.830	.248	.257	5.363	1.681E+07	7.481E+08	.012	.002	.075	.257
Range		1	.62	10	1	1	10	21376	118083	1	.27	1.46	1
Minimum		0	.29	0	0	0	4	282	1727	-0.14	-.04	.62	0
Maximum		1	.91	10	1	1	14	21658	119810	0.45	0.23	2.08	1
Percentiles	25	1.00	.4350	4.00	.00	.00	6.00	888.00	3709.00	.0700	.0150	.8550	.00
	50	1.00	.5800	4.00	1.00	1.00	9.00	1551.00	5172.00	.1400	.0400	.9300	1.00
	75	1.00	.8000	7.00	1.00	1.00	10.00	3429.50	15622.00	.1800	.0650	1.0000	1.00

2007		LDS	COMP	NONEX	COMIT	REP	BSIZE	CSIZE	TASS	ROE	ROA	TOBQ	CGOV
N	Valid	37	37	37	37	37	37	37	37	37	37	37	37
	Missing	0	0	0	0	0	0	0	0	0	0	0	0
Mean		.81	.6741	6.11	.78	.76	9.27	11549.81	38124.84	.2173	.0738	1.2600	.59
Median		1.00	.7300	6.00	1.00	1.00	9.00	5100.00	10257.00	.1800	.0500	1.0600	1.00
Mode		1	.50	6	1	1	9	855[a]	2547[a]	.12[a]	.02	.88[a]	1
Std. Deviation		.397	.20153	2.157	.417	.435	2.143	18978.658	54424.054	.17984	.08417	.64625	.498
Variance		.158	.041	4.655	.174	.189	4.592	3.602E+08	2.962E+09	.032	.007	.418	.248
Range		1	.72	10	1	1	11	97090	221514	.94	.36	3.81	1
Minimum		0	.20	2	0	0	4	855	2547	.03	.01	.58	0
Maximum		1	.92	12	1	1	15	97945	224061	.97	.37	4.39	1
Percentiles	25	1.00	.5000	4.50	1.00	.50	8.00	2690.50	6213.50	.1200	.0200	.9700	.00
	50	1.00	.7300	6.00	1.00	1.00	9.00	5100.00	10257.00	.1800	.0500	1.0600	1.00
	75	1.00	.8700	8.00	1.00	1.00	11.00	11225.50	56299.50	.2550	.0850	1.2850	1.00

Appendix 2

Results of T-test of Corporate Governance and Firm Performance Variables

Test Statistics[b]

	LDS2 - LDS1
Z	-.378[a]
Asymp. Sig. (2-tailed)	.705

a. Based on positive ranks.

b. Wilcoxon Signed Ranks Test

Test Statistics[b]

	REP2 - REP1
Z	-2.496[a]
Asymp. Sig. (2-tailed)	.013

a. Based on negative ranks.

b. Wilcoxon Signed Ranks Test

Test Statistics[b]

	COMP2 - COMP1
Z	-3.067[a]
Asymp. Sig. (2-tailed)	.002

a. Based on negative ranks.

b. Wilcoxon Signed Ranks Test

Test Statistics[b]

	COGV2 - COGV1
Z	-.832[a]
Asymp. Sig. (2-tailed)	.405

a. Based on negative ranks.

b. Wilcoxon Signed Ranks Test

Test Statistics[b]

	NONEX2 - NONEX1
Z	-3.747[a]
Asymp. Sig. (2-tailed)	.000

a. Based on negative ranks.

b. Wilcoxon Signed Ranks Test

Test Statistics[b]

	BSIZE2 - BSIZE1
Z	-3.079[a]
Asymp. Sig. (2-tailed)	.002

a. Based on negative ranks.

b. Wilcoxon Signed Ranks Test

Test Statistics[b]

	COMIT2 - COMIT1
Z	-2.333[a]
Asymp. Sig. (2-tailed)	.020

a. Based on negative ranks.

b. Wilcoxon Signed Ranks Test

Test Statistics[b]

	ROE2 - ROE1
Z	-3.121[a]
Asymp. Sig. (2-tailed)	.002

a. Based on negative ranks.

b. Wilcoxon Signed Ranks Test

Test Statistics[b]

	ROA2 - ROA1
Z	-2.541[a]
Asymp. Sig. (2-tailed)	.011

a. Based on negative ranks.

b. Wilcoxon Signed Ranks Test

Test Statistics[b]

	TOBQ2 - TOBQ1
Z	-4.258[a]
Asymp. Sig. (2-tailed)	.000

a. Based on negative ranks.

b. Wilcoxon Signed Ranks Test

Appendix 3

Spearman's Correlation

2003

	LDS	COMP	NONEX	COMIT	REP	BSIZE	CSIZE	TASS	ROE	ROA	TOBQ
LDS	1	0.058533	0.214591	0.084763	0.158595	0.299773	0.065244	-0.03777	0.096326	0.02763	0.113419
	.	0.73076	0.202158	0.617923	0.348481	0.071456	0.701237	0.824348	0.570619	0.871044	0.503887
	37	37	37	37	37	37	37	37	37	37	37
COMP	0.058533	1	0.800757	0.292097	0.175203	0.040182	0.200892	0.417713	0.117959	-0.24492	0.252648
	0.73076	.	0.000001	0.079387	0.299648	0.813338	0.233167	0.010098	0.486853	0.144012	0.13139
	37	37	37	37	37	37	37	37	37	37	37
NONEX	0.214591	0.800757	1	0.375034	0.332075	0.585058	0.131534	0.488486	0.096369	-0.30814	0.103449
	0.202158	0.000001	.	0.022188	0.044645	0.000143	0.437742	0.002159	0.570449	0.063529	0.542328
	37	37	37	37	37	37	37	37	37	37	37
COMIT	0.084763	0.292097	0.375034	1	0.628076	0.167484	0.371235	0.448576	0.348674	0.049266	0.061928
	0.617923	0.079387	0.022188	.	3.16E-05	0.321774	0.023688	0.005359	0.034431	0.772148	0.715775
	37	37	37	37	37	37	37	37	37	37	37
REP	0.158595	0.175203	0.332075	0.628076	1	0.257061	0.377326	0.240577	0.362799	0.160466	0.096316
	0.348481	0.299648	0.044645	3.16E-05	.	0.124559	0.021321	0.151484	0.027323	0.342752	0.570658
	37	37	37	37	37	37	37	37	37	37	37
BSIZE	0.299773	0.040182	0.585058	0.167484	0.257061	1	-0.02431	0.293758	-0.0938	-0.30278	-0.17513
	0.071456	0.813338	0.000143	0.321774	0.124559	.	0.886437	0.077615	0.580813	0.068519	0.299838
	37	37	37	37	37	37	37	37	37	37	37
CSIZE	0.065244	0.200892	0.131534	0.371235	0.377326	-0.02431	1	0.565145	0.498843	0.335545	0.45838
	0.701237	0.233167	0.437742	0.023688	0.021321	0.886437	.	0.000268	0.001674	0.042329	0.004329
	37	37	37	37	37	37	37	37	37	37	37
TASS	-0.03777	0.417713	0.488486	0.448576	0.240577	0.293758	0.565145	1	0.252153	-0.28034	0.35313
	0.824348	0.010098	0.002159	0.005359	0.151484	0.077615	0.000268	.	0.132172	0.092845	0.032042
	37	37	37	37	37	37	37	37	37	37	37
ROE	0.096326	0.117959	0.096369	0.348674	0.362799	-0.0938	0.498843	0.252153	1	0.587509	0.487221
	0.570619	0.486853	0.570449	0.034431	0.027323	0.580813	0.001674	0.132172	.	0.000132	0.002226
	37	37	37	37	37	37	37	37	37	37	37
ROA	0.02763	-0.24492	-0.30814	0.049266	0.160466	-0.30278	0.335545	-0.28034	0.587509	1	0.129611
	0.871044	0.144012	0.063529	0.772148	0.342752	0.068519	0.042329	0.092845	0.000132	.	0.444528
	37	37	37	37	37	37	37	37	37	37	37
TOBQ	0.113419	0.252648	0.103449	0.061928	0.096316	-0.17513	0.45838	0.35313	0.487221	0.129611	1
	0.503887	0.13139	0.542328	0.715775	0.570658	0.299838	0.004329	0.032042	0.002226	0.444528	.
	37	37	37	37	37	37	37	37	37	37	37
Correlation is significant at the 0.01 level (2-tailed).											
Correlation is significant at the 0.05 level (2-tailed).											

2007

	LDS	COMP	NONEX	COMIT	REP	BSIZE	CSIZE	TASS	ROE	ROA	TOBQ
LDS	1	0.35951	0.294849	-0.08608	-0.27386	0.003284	0.025852	0.122798	0.365466	0.029244	0.061425
	.	0.028859	0.076467	0.612455	0.100967	0.984608	0.879281	0.469028	0.026127	0.863584	0.717989
	37	37	37	37	37	37	37	37	37	37	37
COMP	0.35951	1	0.857879	0.080117	0.153745	-0.07474	0.224546	0.207438	0.134483	-0.10142	0.124087
	0.028859	.	0.000001	0.637378	0.363607	0.660186	0.181511	0.217971	0.427448	0.55031	0.464341
	37	37	37	37	37	37	37	37	37	37	37
NONEX	0.294849	0.857879	1	0.137144	0.212337	0.339054	0.266307	0.375786	0.097062	-0.15231	0.110005
	0.076467	0.000001	.	0.418276	0.207053	0.040087	0.111114	0.0219	0.567667	0.368146	0.516893
	37	37	37	37	37	37	37	37	37	37	37
COMIT	-0.08608	0.080117	0.137144	1	0.008272	0.190608	0.166023	0.135278	-0.18155	-0.06183	0.055364
	0.612455	0.637378	0.418276	.	0.961248	0.258466	0.326074	0.424697	0.282211	0.716213	0.744836
	37	37	37	37	37	37	37	37	37	37	37
REP	-0.27386	0.153745	0.212337	0.008272	1	0.134917	0.082599	0.064899	-0.00295	-0.06822	0.168218
	0.100967	0.363607	0.207053	0.961248	.	0.425944	0.626954	0.702743	0.986163	0.688269	0.319627
	37	37	37	37	37	37	37	37	37	37	37
BSIZE	0.003284	-0.07474	0.339054	0.190608	0.134917	1	0.119874	0.439858	-0.00549	-0.17414	-0.10588
	0.984608	0.660186	0.040087	0.258466	0.425944	.	0.479759	0.006447	0.974292	0.302646	0.53282
	37	37	37	37	37	37	37	37	37	37	37
CSIZE	0.025852	0.224546	0.266307	0.166023	0.082599	0.119874	1	0.512802	0.082453	0.014303	0.554165
	0.879281	0.181511	0.111114	0.326074	0.626954	0.479759	.	0.001173	0.627564	0.933041	0.000373
	37	37	37	37	37	37	37	37	37	37	37
TASS	0.122798	0.207438	0.375786	0.135278	0.064899	0.439858	0.512802	1	-0.17499	-0.56497	-0.14835
	0.469028	0.217971	0.0219	0.424697	0.702743	0.006447	0.001173	.	0.300241	0.000269	0.380869
	37	37	37	37	37	37	37	37	37	37	37
ROE	0.365466	0.134483	0.097062	-0.18155	-0.00295	-0.00549	0.082453	-0.17499	1	0.607844	0.40419
	0.026127	0.427448	0.567667	0.282211	0.986163	0.974292	0.627564	0.300241	.	6.6E-05	0.013098
	37	37	37	37	37	37	37	37	37	37	37
ROA	0.029244	-0.10142	-0.15231	-0.06183	-0.06822	-0.17414	0.014303	-0.56497	0.607844	1	0.395164
	0.863584	0.55031	0.368146	0.716213	0.688269	0.302646	0.933041	0.000269	6.6E-05	.	0.015494
	37	37	37	37	37	37	37	37	37	37	37
TOBQ	0.061425	0.124087	0.110005	0.055364	0.168218	-0.10588	0.554165	-0.14835	0.40419	0.395164	1
	0.717989	0.464341	0.516893	0.744836	0.319627	0.53282	0.000373	0.380869	0.013098	0.015494	.
	37	37	37	37	37	37	37	37	37	37	37
Correlation is significant at the 0.05 level (2-tailed).											
Correlation is significant at the 0.01 level (2-tailed).											

Appendix 4

Analysis of Variance 2003

Tests of Between-Subjects Effects

Source	Dependent Variable	Type III Sum of Squares	df	Mean Square	F	Sig.
Corrected Model	ROE	.330[a]	30	.011	.644	.805
	ROA	.065[b]	30	.002	1.064	.518
	TOBQ	1.624[c]	30	.054	.305	.987
Intercept	ROE	.340	1	.340	19.875	.004
	ROA	.022	1	.022	10.881	.016
	TOBQ	17.723	1	17.723	99.992	.000
LDS	ROE	.007	1	.007	.398	.551
	ROA	.006	1	.006	2.788	.146
	TOBQ	.034	1	.034	.192	.677
COMP	ROE	.235	19	.012	.723	.728
	ROA	.044	19	.002	1.135	.473
	TOBQ	1.055	19	.056	.313	.976
COMIT	ROE	.003	1	.003	.199	.672
	ROA	.003	1	.003	1.674	.243
	TOBQ	.143	1	.143	.807	.404
LDS * COMP	ROE	.026	1	.026	1.498	.267
	ROA	.010	1	.010	4.932	.068
	TOBQ	.006	1	.006	.036	.856
COMP * COMIT	ROE	.027	7	.004	.229	.963
	ROA	.017	7	.002	1.220	.412
	TOBQ	.429	7	.061	.346	.905

Appendix 5

Analysis of Variance 2007

Tests of Between-Subjects Effects

Source	Dependent Variable	Type III Sum of Squares	df	Mean Square	F	Sig.
Corrected Model	ROE	1.139[a]	28	.041	12.786	.000
	ROA	.224[b]	28	.008	2.080	.141
	TOBQ	14.620[c]	28	.522	10.060	.001
Intercept	ROE	.677	1	.677	212.849	.000
	ROA	.080	1	.080	20.653	.002
	TOBQ	29.246	1	29.246	563.473	.000
LDS	ROE	.034	1	.034	10.782	.011
	ROA	.001	1	.001	.134	.724
	TOBQ	.046	1	.046	.894	.372
COMP	ROE	.937	21	.045	14.028	.000
	ROA	.199	21	.009	2.458	.096
	TOBQ	12.891	21	.614	11.827	.001
COMIT	ROE	.065	1	.065	20.332	.002
	ROA	.012	1	.012	3.055	.119
	TOBQ	.298	1	.298	5.746	.043
LDS * COMP	ROE	.031	3	.010	3.290	.079
	ROA	.015	3	.005	1.276	.346
	TOBQ	.537	3	.179	3.450	.072
COMP * COMIT	ROE	.013	1	.013	4.157	.076
	ROA	.000	1	.000	.026	.876
	TOBQ	.378	1	.378	7.287	.027

Appendix 6

CODE OF BEST PRACTICE ON CORPORATE GOVERNANCE IN SRI LANKA

SECTION 1 : THE COMPANY

A DIRECTORS

A.1 THE BOARD

Principle A.1 Every public company should be headed by an effective Board, which should direct, lead and control the Company.

A.1.1 The Board should meet regularly. Board meetings should be held at least once in every quarter of a financial year.

A.1.2 The Board should be responsible for matters including:

- ensuring the formulation and implementation of a sound business strategy;
- ensuring that the Chief Executive Officer (CEO) and management team possess the skills, experience and knowledge to implement the strategy;
- ensuring the adoption of an effective CEO and senior management succession strategy;
- ensuring effective systems to secure integrity of information, internal controls and risk management;
- ensuring compliance with laws, regulations and ethical standards;
- ensuring all stakeholder interests are considered in corporate decisions;
- ensuring that the company's values and standards are set with emphasis on adopting appropriate accounting policies and fostering compliance with financial regulations; and
- fulfilling such other Board functions as are vital, given the scale, nature and complexity of the business concerned.

A.1.3 The Board collectively, and Directors individually, must act in accordance with the laws of the Country, as applicable to the business enterprise. There should be a procedure agreed to by the Board of Directors, to obtain independent professional advice where necessary, at the Company's expense.

A.1.4 All Directors should have access to the advice and services of the Company Secretary, who is responsible to the Board in ensuring that Board procedures are followed and that applicable rules and regulations are complied with. Any question of the removal of the Company Secretary should be a matter for the Board as a whole.

A.1.5 All Directors should bring independent judgment to bear on issues of strategy, performance, resources (including key appointments) and standards of business conduct.

A. 1.6 Every Director should dedicate adequate time and effort to matters of the Board and the Company, to ensure that the duties and responsibilities owed to the Company are satisfactorily discharged. It must be recognised that Directors have to dedicate sufficient time before a meeting to review Board papers and call for additional information and clarification, and after a meeting to follow up on issues consequent to the meeting. This should be supplemented by a time allocation for familiarisation with business changes, operations, risks and controls.

A. 1.7 Every Director should receive appropriate training when first appointed to the Board of a company, and subsequently as necessary. Training curricula should encompass both general aspects of directorship and matters specific to the particular industry/company concerned. A Director must recognise that there is a need for continuous training and an expansion of the knowledge and skills required to effectively perform his duties as a Director.

CHAIRMAN AND CHIEF EXECUTIVE OFFICER (CEO)

Principle A.2 There are two key tasks at the top of every public company – conducting of the business of the Board, and facilitating executive responsibility for management of the Company's business. There should be a clear division of responsibilities at the head of the Company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision.

A.2.1 A decision to combine the posts of Chairman and CEO in one person should be justified and highlighted in the Annual Report.

A.3 CHAIRMAN'S ROLE

Principle A.3 The Chairman's role in preserving good Corporate Governance is crucial. As the person responsible for running the Board, the Chairman should preserve order and facilitate the effective discharge of Board functions.

A. 3.1 The Chairman should conduct Board proceedings in a proper manner and ensure, inter-alia, that:

- the effective participation of both Executive and Non-Executive Directors is secured;
- all Directors are encouraged to make an effective contribution, within their respective capabilities, for the benefit of the Company;
- a balance of power between Executive and Non-Executive Directors is maintained;
- the views of Directors on issues under consideration are ascertained; and •
- the Board is in complete control of the Company's affairs and alert to its obligations to all shareholders and other stakeholders.

A.4 FINANCIAL ACUMEN

Principle A.4 The Board should ensure the availability within it of those with sufficient financial acumen and knowledge to offer guidance on matters of finance.

A.5 BOARD BALANCE

Principle A.5 It is preferable for the Board to have a balance of Executive and Non-Executive Directors such that no individual or small group of individuals can dominate the Board's decision-taking.

A.5.1 The Board should include Non-Executive Directors of sufficient calibre and number for their views to carry significant weight in the Board's decisions. The Board should include at least two Non-Executive Directors or such number of Non-Executive Directors equivalent to one third of total number of directors, whichever is higher. In the event the Chairman and CEO is the same person, Non-Executive Directors should comprise a majority of the Board.

The total number of directors is to be calculated based on the number as at the conclusion of the immediately preceding Annual General Meeting. Further, any change occurring to this ratio should be rectified within 90 days from the date of the change.

A.5.2 Where the constitution of the Board of Directors includes only two Non-Executive Directors, both such Non-Executive Directors should be 'independent'. In all other instances two or one third of Non-Executive Directors appointed to the Board of Directors whichever is higher should be 'independent'.

A.5.3 For a Director to be deemed 'independent' such Director should be independent of management and free of any business or other relationship that could materially interfere with or could reasonably be perceived to materially interfere with the exercise of their unfettered and independent judgment.

A.5.4 Each Non-Executive Director should submit a signed and dated declaration annually of his/her independence or non-independence against the specified criteria set out in the Specimen in Schedule H.

A.5.5 The Board should make a determination annually as to the independence or non-independence of each Non-Executive Director based on such a declaration made of decided criteria and other information available to the Board, and should set out in the Annual Report the names of directors determined to be 'independent'.

The Board should specify the criteria not met and the basis for its determination in the annual report, if it determines that a Director is independent notwithstanding the existence of relationships or circumstances which indicate the contrary.

A Director would not be independent if he/she:

- has been employed by the Company during the period of two years immediately preceding appointment as director;
- currently has/had during the period of two years immediately preceding appointment as director, a Material Business Relationship with the Company, whether directly or indirectly;
- has a close family member who is a director, chief executive officer (and/or an equivalent position) in the Company;
- has a Significant Shareholding in the Company;
- has served on the Board of the Company continuously for a period exceeding nine years from the date of the first appointment;
- is employed in another company or business:
- in which a majority of the other directors of the Company are employed or are directors; or
- in which a majority of the other directors of the Company have a Significant Shareholding or Material Business Relationship; or
- that has a Significant Shareholding in the Company or with which the Company has a Business Connection;
- is a director of another company:
- in which a majority of the other directors of the Company are employed or are directors; or
- that has a Business Connection in the Company or Significant Shareholding;
- has a Material Business Relationship or a Significant Shareholding in another company or business:
- in which a majority of the other directors of the Company are employed or are directors; and/or
- which has a Business Connection with the Company or Significant Shareholding in the same.

The above list is not exhaustive, and should be viewed as a guide rather than a set of rules on the basis of which independence can be conclusively determined.

DEFINITIONS RELATING TO INDEPENDENCE CRITERIA

Close Family Member - shall mean and include the director's spouse, parents, grandparents, children, brothers, sisters, grandchildren and any person who is financially dependent on such director.

Financially Dependent Individuals - include any person who received more than half of their support for the most recent fiscal year from a director and/or his or her spouse.

Material Business Relationship - includes any relationship that results in income/non-cash benefits equivalent to 10% of the director's annual income.

Business Connection - shall mean a relationship resulting in transaction value equivalent to 10% of the turnover of that company or business.

Significant Shareholdings -can be defined as a shareholding carrying not less than 10% of the voting rights of a company.

A.5.6 In the event the Chairman and CEO is the same person, the Board should appoint one of the independent Non-Executive Directors to be the "Senior Independent Director" (SID) and disclose this appointment in the Annual Report.

A.5.7 The Senior Independent Director should make himself available for confidential discussions with other Directors who may have concerns which they believe have not been properly considered by the Board as a whole and which pertain to significant issues that are detrimental to the Company.

A.5.8 The Chairman should hold meetings with the Non-Executive Directors only, without the Executive Directors being present, as necessary and at least once each year.

A.5.9 Where Directors have concerns about the matters of the Company which cannot be unanimously resolved, they should ensure their concerns are recorded in the Board Minutes.

A.6 SUPPLY OF INFORMATION

Principle A.6 The Board should be provided with timely information in a form and of a quality appropriate to enable it discharge its duties.

A.6.1 Management has an obligation to provide the Board with appropriate and timely information, but information volunteered by management may not be enough in all circumstances and Directors should make further inquiries where necessary. The Chairman should ensure all Directors are properly briefed on issues arising at Board meetings.

A.6.2 The minutes, agenda and papers required for a Board Meeting should ordinarily be provided to Directors at least seven (7) days before the meeting, to facilitate its effective conduct.

A.7 APPOINTMENTS TO THE BOARD

Principle A.7 There should be a formal and transparent procedure for the appointment of new Directors to the Board.

A.7.1 A Nomination Committee should be established to make recommendations to the Board on all new Board appointments. Terms of Reference for Nomination Committees are set out in Schedule A. The Chairman and members of the Nomination Committee should be identified in the Annual Report.

A.7.2 The Nomination Committee or in the absence of a nomination committee, the Board as a whole should annually assess board-composition to ascertain whether the combined knowledge and experience of the Board matches the strategic demands facing the Company. The findings of such assessment should be taken into account when new board appointments are considered and when incumbent directors come up for re-election.

A.7.3 Upon the appointment of a new Director to the Board, the Company should forthwith disclose to shareholders:

- a brief resume of the Director;
- the nature of his expertise in relevant functional areas;
- the names of companies in which the Director holds directorships or memberships in Board committees; and
- whether such director can be considered 'independent'.

A.8 RE-ELECTION

Principle A.8 All Directors should be required to submit themselves for re-election at regular intervals and at least once in every three years.

A.8.1 Non-Executive Directors should be appointed for specified terms subject to re-election and to the provisions in the Companies Act relating to the removal of a Director, and their re-appointment should not be automatic.

A.8.2 All Directors including the Chairman of the Board, should be subject to election by shareholders at the first opportunity after their appointment, and to re-election thereafter at intervals of no more than three years. The names of Directors submitted for election or re-election should be accompanied by a resume minimally as set out in paragraph A.7.3 above, to enable shareholders to make an informed decision on their election.

A.9 APPRAISAL OF BOARD PERFORMANCE

Principle A.9 Boards should periodically appraise their own performance in order to ensure that Board responsibilities are satisfactorily discharged.

A.9.1 The Board should annually appraise itself on its performance in the discharge of its key responsibilities as set out in A.1.2.

Schedule B contains a sample "Board Performance Evaluation Checklist" that may be used for this purpose.

A.9.2 The Board should also undertake an annual self-evaluation of its own performance and that of its Committees.

A.9.3 The Board should state how such performance evaluations have been conducted, in the Annual Report.

A.10 DISCLOSURE OF INFORMATION IN RESPECT OF DIRECTORS

Principle A.10 Shareholders should be kept advised of relevant details in respect of Directors.

A.10.1 The Annual Report of the Company should set out the following information in relation to each Director: •

- name, qualifications and brief profile;
- the nature of his/her expertise in relevant functional areas;
- immediate family and/or material business relationships with other Directors of the Company;
- names of listed companies in Sri Lanka in which the Director concerned serves as a Director;
- names of other companies in which the Director concerned serves as a Director, provided that where he/she holds directorships in companies within a Group of which the Company is a part, their names need not be disclosed; it is sufficient to state that he/she holds other directorships in such companies;
- number/percentage of board meetings of the Company attended during the year;
- names of Board Committees in which the Director serves as Chairman or a member; and
- number/percentage of committee meetings attended during the year.

A.11 APPRAISAL OF CHIEF EXECUTIVE OFFICER (CEO)

Principle A.11 The Board should be required, at least annually, to assess the performance of the CEO.

A.11.1 At the commencement of every fiscal year, the Board in consultation with the CEO, should set, in line with the short, medium and long-term objectives of the Company, reasonable financial and non-financial targets that should be met by the CEO during the year.

A.11.2 The performance of the CEO should be evaluated by the Board at the end of each fiscal year to ascertain whether the targets set by the Board have been achieved and if not, whether the failure to meet such targets was reasonable in the circumstances.

B DIRECTORS' REMUNERATION

B.1 REMUNERATION PROCEDURE

Principle B.1 Companies should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual Directors. No Director should be involved in deciding his/her own remuneration.

B.1.1 To avoid potential conflicts of interest, the Board of Directors should set up a Remuneration Committee to make recommendations to the Board, within agreed terms of reference, on the Company's framework of remunerating executive directors. (These also include Post Employment Benefits as well as Terminal Benefits) Terms of Reference for Remuneration Committees are set out in Schedule C.

B.1.2 Remuneration Committees should consist exclusively of Non-Executive Directors, and should have a Chairman, who should be appointed by the Board.

B.1.3 The Chairman and members of the Remuneration Committee should be listed in the Annual Report each year.

B.1.4 The Board as a whole, or where required by the Articles of Association the shareholders, should determine the remuneration of Non-Executive Directors, including members of the Remuneration Committee, within the limits set in the Articles of Association. Where permitted by the Articles, the Board may delegate this responsibility to a sub-committee of the Board, which might include the CEO.

B.1.5 The Remuneration Committee should consult the Chairman and/or CEO about its proposals relating to the remuneration of other Executive Directors and have access to professional advice from within and outside the Company, in discharging their responsibilities.

B.2 THE LEVEL AND MAKE UP OF REMUNERATION

Principle B.2 Levels of remuneration of both Executive and Non-Executive Directors should be sufficient to attract and retain the Directors needed to run the Company successfully. A proportion of Executive Directors' remuneration should be structured to link rewards to corporate and individual performance.

B.2.1 The Remuneration Committee should provide the packages needed to attract, retain and motivate Executive Directors of the quality required but should avoid paying more than is necessary for this purpose.

B.2.2 The Remuneration Committee should judge where to position levels of remuneration of the Company, relative to other companies. It should be aware what comparable companies are paying and should take account of relative performance, but should use such comparisons with caution, mindful of the risk that they can result in an increase of remuneration levels with no corresponding improvement in performance.

B.2.3 The Remuneration Committee should be sensitive to remuneration and employment conditions elsewhere in the Company or Group of which it is a part, especially when determining annual salary increases.

B.2.4 The performance-related elements of remuneration of Executive Directors should be designed and tailored to align their interests with those of the Company and main stakeholders and to give these Directors appropriate incentives to perform at the highest levels.

B.2.5 Executive share options should not be offered at a discount (i.e. less than market price prevailing at the time the exercise price is determined), save as permitted by the Listing Rules of the Stock Exchange.

B.2.6 In designing schemes of performance-related remuneration, Remuneration Committees should follow the provisions set out in Schedule D.

B.2.7 Remuneration Committees should consider what compensation commitments (including pension contributions) their Directors' contracts of service, if any, entail in the event of early termination. Remuneration Committees should in particular, consider the advantages of providing explicitly for such compensation commitments to apply other than in the case of removal for misconduct, in initial contracts.

B.2.8 Where the initial contract does not explicitly provide for compensation commitments, Remuneration Committees should, within legal constraints, tailor their approach in early termination cases to the relevant circumstances. The broad aim should be, to avoid rewarding poor performance while dealing fairly with cases where departure is not due to poor performance.

B.2.9 Levels of remuneration for Non-Executive Directors should reflect the time commitment and responsibilities of their role, taking into consideration market practices. Remuneration for Non-Executive Directors should not normally include share options. If exceptionally options are granted, shareholder approval should be sought in advance and any shares acquired by exercise of the options should be held until at least one year after the Non-Executive Director leaves the Board. Holding share options could be relevant to the determination of a Non-Executive Director's independence. (as set out in provision A.5.5)

B.3 DISCLOSURE OF REMUNERATION

Principle B.3 The Company's Annual Report should contain a Statement of Remuneration Policy and details of remuneration of the Board as a whole.

B.3.1 The Annual Report should set out the names of directors (or persons in the parent company's committee in the case of a group company) comprising the remuneration committee, contain a statement of remuneration policy and set out the aggregate remuneration paid to Executive and Non-Executive Directors.

C RELATIONS WITH SHAREHOLDERS

C.1 CONSTRUCTIVE USE OF THE ANNUAL GENERAL MEETING (AGM) AND CONDUCT OF GENERAL MEETINGS

Principle C.1 Boards should use the AGM to communicate with shareholders and should encourage their participation.

C.1.1 Companies should count all proxy votes and should indicate the level of proxies lodged on each resolution, and the balance for and against the resolution, after it has been dealt with on a show of hands, except where a poll is called.

C.1.2 Companies should propose a separate resolution at the AGM on each substantially separate issue and should in particular propose a resolution at the AGM relating to the adoption of the report and accounts.

C.1.3 The Chairman of the Board should arrange for the Chairmen of the Audit, Remuneration and Nomination Committees to be available to answer questions at the AGM if so requested by the Chairman.

C.1.4 Companies should arrange for the Notice of the AGM and related papers to be sent to shareholders as determined by statute, before the meeting.

C.1.5 Companies should circulate with every Notice of General Meeting, a summary of the procedures governing voting at General Meetings.

MAJOR TRANSACTIONS

Principle C.2 Further to compliance with the requirements under the Companies Act, directors should disclose to shareholders all proposed corporate transactions, which if entered into, would materially alter/vary the Company's net assets base or in the case of a company with subsidiaries, the consolidated group net asset base.

C.2.1 Prior to a company engaging in or committing to a 'Major Transaction', involving the acquisition, sale or disposition of greater than half of the net value of the Company's assets or that of a subsidiary which has a material bearing on the consolidated net assets of the Company, or a transaction which has or is likely to have the effect of the company acquiring obligations and liabilities, Directors should disclose to shareholders all material facts of such transaction. It also includes transactions or series of related transactions which have the purpose of effect of substantially altering the nature of the business carried on by the Company.

D ACCOUNTABILITY AND AUDIT

FINANCIAL REPORTING

Principle D.1 The Board should present a balanced and understandable assessment of the Company's financial position, performance and prospects.

D.1.1 The Board's responsibility to present a balanced and understandable assessment extends to interim and other price-sensitive public reports and reports to regulators, as well as to information required to be presented by statutory requirements.

D.1.2 The Directors' Report, which forms part of the Annual Report, should contain declarations by the Directors to the effect that:

- the Company has not engaged in any activity which contravenes laws and regulations;
- the Directors have declared all material interests in contracts involving the Company and refrained from voting on matters in which they were materially interested;
- the Company has made all endeavours to ensure the equitable treatment of shareholders;

- the business is a going concern, with supporting assumptions or qualifications as necessary; and
- they have conducted a review of the internal controls, covering financial, operational and compliance controls and risk management, and have obtained reasonable assurance of their effectiveness and successful adherence therewith,
- and, if it is unable to make any of these declarations, to explain why it is unable to do so.

D.1.3 The Annual Report should contain a statement setting out the responsibilities of the Board for the preparation and presentation of financial statements, together with a statement by the Auditors about their reporting responsibilities.
D.1.4 The Annual Report should contain a "Management Discussion & Analysis", discussing, among other issues:

- industry structure and developments; • opportunities and threats;
- risks and concerns;
- internal control systems and their adequacy ;
- social and environmental protection activities carried out by the Company;
- financial performance;
- material developments in human resource / industrial relations; and
- prospects for the future.

D.1.5 The Directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary. The matters to which the Board should give due consideration when adopting the going concern assumption are set out in Schedule E to this Code.
D.1.6 In the event the net assets of the Company fall below 50% of the value of the Company's shareholders' funds, the Directors shall forthwith summon an Extraordinary General Meeting of the Company to notify shareholders of the position and of remedial action being taken.

D.2 INTERNAL CONTROL
Principle D.2 The Board should maintain a sound system of internal control to safeguard shareholders' investments and the Company's assets.
D. 2.1 The Directors should, at least annually, conduct a review of the effectiveness of the Group's system of internal controls, so as to be able to report to shareholders as required in D.1.2. This could be made the responsibility of the Audit Committee.
D. 2.2 Companies which do not have an internal audit function should from time to time review the need for one.

D.3 AUDIT COMMITTEE
Principle D.3 The Board should establish formal and transparent arrangements for considering how they should select and apply accounting policies, financial reporting and internal control principles and maintaining an appropriate relationship with the Company's Auditors.
D.3.1 The Audit Committee should be comprised of a 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 of whom should be independent, whichever is higher.
The Chairman of the Committee should be a Non-Executive Director, appointed by the Board.
D.3.2 The duties of the Audit Committee should include keeping under review the scope and results of the audit and its effectiveness, and the independence and objectivity of the Auditors. Where the Auditors also supply a substantial volume of non-audit services to the Company, the Committee should keep the nature and extent of such services under review, seeking to balance objectivity, independence and value for money.
D.3.3 The Audit Committee should have a written Terms of Reference, dealing clearly with its authority and duties. The Audit Committee's written Terms of Reference must address:

- The Committee's purpose – which, at minimum, must be to:
- Assist Board oversight of the:
- preparation, presentation and adequacy of disclosures in the financial statements, in accordance with Sri Lanka Accounting Standards;
- company's compliance with financial reporting requirements, information requirements of the Companies Act and other relevant financial reporting related regulations and requirements;
- processes to ensure that the Company's internal controls and risk management procedures are adequate to meet the requirements of the Sri Lanka Auditing Standards;
- assessing the Company's ability to continue as a going concern in the foreseeable future; and
- independence and performance of the Company's external auditors.
- The duties and responsibilities of the Audit Committee – which, at a minimum must include those set out in the Code of Best Practice on Audit Committees issued by the Institute of Chartered Accountants of Sri Lanka in 2002, and also:
- make recommendations to the Board, pertaining to appointment, re-appointment and removal of external auditors and to approve the remuneration and terms of engagement of the external auditors;
- discussion of the audit plan, key audit issues and their resolution, management responses and the proposed remuneration of the Auditor;
- discussion of the Company's annual audited financial statements and quarterly financial statements with management and the auditor;
- discussion of the Company's earnings press releases and financial information and earnings guidance provided to analysts and rating agencies;
- discussion of policies and practices with respect to risk assessment and risk management;
- meeting separately, periodically, with management, auditors and internal auditors;
- establishing mechanisms for the confidential receipt, retention and treatment of complaints alleging fraud, received from internal/external sources and pertaining to accounting, internal controls or other such matters;
- assuring confidentiality to whistle-blowing employees;
- setting clear hiring policies for employees or former employees of the auditors; and
- reporting regularly to the Board of Directors.

- Detailed guidance on the scope and functions of the Audit Committee can be found in the Code of Best Practice on Audit Committees issued by the Institute of Chartered Accountants of Sri Lanka in 2002.

D.3.4 DISCLOSURES
The names of directors (persons in the parent company's committee in the case of a group company) comprising the Audit Committee should be disclosed in the Annual Report.
The Committee should also make a determination of the independence of the auditors and should disclose the basis of such determination in the Annual Report.
The Annual Report should contain a report by the Audit Committee, setting out the manner of compliance by the Company, in relation to the above, during the period to which the Annual Report relates.
CODE OF BUSINESS CONDUCT & ETHICS
Principle D.4 Companies must adopt a Code of Business Conduct & Ethics for directors, and members of the senior management team and must promptly disclose any waivers of the Code for directors or others.
D.4.1 All Companies must disclose whether they have a Code of Business Conduct & Ethics for directors and members of the senior management team and if they have such a Code, make an affirmative declaration in the Annual Report that all directors and members of the senior management team have complied with such Code, and if unable to make that declaration, state why they are unable to do so. Each Company may determine its own policies in the formulation of such a Code, but all Companies should address the following important topics in their respective Codes:

- conflict of interest;
- corporate opportunities;
- confidentiality;
- fair dealing;
- protection and proper use of company assets;
- compliance with laws, rules and regulations (including insider trading laws); and
- encouraging the reporting of any illegal or unethical behaviour.

These aspects are expanded on, in Schedule G.
D.4.2 The Chairman must affirm in the Company's Annual Report that he is not aware of any violation of any of the provisions of the Code of Business Conduct & Ethics.

D.5 CORPORATE GOVERNANCE DISCLOSURES
Principle D.5 Directors should be required to disclose the extent to which the Company adheres to established principles and practices of good Corporate Governance.
D.5.1 The Directors should include in the Company's Annual Report a Corporate Governance Report, setting out the manner and extent to which the Company has complied with the principles and provisions of this Code.

SECTION 2: SHAREHOLDERS

E INSTITUTIONAL INVESTORS
E.1 SHAREHOLDER VOTING
Principle E.1 Institutional shareholders have a responsibility to make considered use of their votes and should be encouraged to ensure their voting intentions are translated into practice.
E.1.1 A listed company should conduct a regular and structured dialogue with shareholders based on a mutual understanding of objectives. Arising from such dialogue, the Chairman should ensure the views of shareholders are communicated to the Board as a whole.

E.2 EVALUATION OF GOVERNANCE DISCLOSURES
Principle E.2 When evaluating Companies' governance arrangements, particularly those relating to board structure and composition, institutional investors should be encouraged to give due weight to all relevant factors drawn to their attention.

F OTHER INVESTORS
F.1 INVESTING/ DIVESTING DECISION
Principle F.1 Individual shareholders, investing directly in shares of companies should be encouraged to carry out adequate analysis or seek independent advice in investing or divesting decisions.
F.2 SHAREHOLDER VOTING
Principle F.2 Individual shareholders should participate in General Meetings exercise their voting rights. be of encouraged to companies and