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# Corporate governance from colonial Ceylon to post-civil war Sri Lanka

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## Abstract

This paper examines the corporate governance mechanisms in Sri Lanka, a country that only a little more than a decade ago emerged from a 30-year long civil war. We focus on the evolution of Sri Lanka's corporate governance from historical, socioocultural, and institutional perspectives. Taking Sri Lanka as a case where inclusiveness and reconciliation at the board level is important, we aim to diagnose the key corporate governance issues which we then broaden towards other South Asia developing countries and provide a research agenda. Many Sri Lankan firms suffer from typical Asian-style agency problems; conflicts of interest between (i) minority and majority shareholders, (ii) shareholders and debtholders, and (iii) shareholders and stakeholders. The most prevalent agency problem is the expropriation of minority shareholders' rights through ownership pyramids, cross-holdings, or intermediate private firms. Although creditor protection laws limit the expropriation of debtholders' rights, firms' widespread use of political connections forces banks to grant cheap credit at favorable terms. Poor stakeholder management creates agency problems following window dressing of ESG disclosures, corporate opacity, and ethnicity-and gender-based discrimination in the workplace. This study shows that social norms and ethical values play a non-negligible role in the functioning of the corporate governance regulation and in corporate culture in Sri Lanka.


**Keywords** Agency problems · Bank-based economy · Corporate control · Corporate social responsibility · Corporate failure · Civil war

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## 1 Introduction

In this paper we examine the corporate governance problems and mechanisms of Sri Lanka, a country that suffers from persistent corruption, nepotistic relations as well as the consequences of a civil war and ethnic conflicts that lasted three decades. We particularly pay attention on the evolution of Sri Lanka's corporate governance from historical and institutional perspectives. We also examine how the ethno-linguistic conflicts and other cultural idiosyncrasies of the country affect the trajectory of Sri Lanka's corporate governance practices. Taking Sri Lanka as a case, we aim to diagnose the key corporate governance problems and mechanisms in the South Asian developing markets, where ethnic, linguistic, and religious tensions abound (e.g. in India, Bangladesh, Pakistan, etc.), study the impact of the globalization of corporate governance regulation on local governance practices, and provide an agenda for future research.

Sri Lanka is a unique social laboratory for investigating diversity and inclusion and other ethical issues associated with corporate governance. The polarization and ethnic conflict in society has dated back to the arrival of the colonial powers. Between 1983 and 2009, the country was torn by civil war and humanitarian crises in which international actors played an implicit role (Ganguly, 2018). The Sri Lankans are separated with the demarcated boundaries depending on the ethno-linguistic and religious fractionalization; the country's population exhibits a multi-facet heterogeneity in terms of religion and ethnicity (Sinhalese account for 74.9% of the population, native Tamils for 11.1%, Indian Tamils for 4.1%, and Moors for 9.3%). Sinhalese are largely Buddhist but about 10% of the Sinhalese are Christian, Tamils are Hindu, and Moors are Muslim (and speak Tamil). We note that the ethnic conflicts and interactions do not only manifest themselves across the communities but also within the corporations. How Sri Lankan corporations are governed and formed are not only the product of institutions but also of social interactions and culture (Nazliben et al., 2022).

Sri Lanka also showcases how corporate governance and corruption are interrelated. According to the corruption perception index (CPI)—constructed by *Transparency International* and reflecting the perception of experts and businesspeople—Sri Lanka's place is in the league of the highly corrupt countries of the world. For instance, based on its CPI score, the country was the 102nd most corrupt country among the180 countries evaluated in 2021; and this problem has persisted across the years. In 2022, soon after the covid crisis and soaring worldwide inflation, the country once more fell into political and economic upheaval, which is perhaps a warning sign for other developing countries in the South Asia region. The country's bond repayment was suspended, the dollar reserves melted, and eventually the country with a 22-million population turned out to be insolvent and face another humanitarian crisis, the risk of famine. The government, run by the Rajapaksa family for decades, is currently seeking for an exit from the crisis with the support of IMF and the other Asian big political powers and creditors, China and India.

Corruption and poor corporate governance practices is an endemic for most developing and emerging market countries. The issue is not confined within the Global South but also a concern of the biggest economies of the world.[1] The relation between these two is a vicious cycle because corruption drives bad corporate governance, and the inverse is also true (Boateng et al., 2021; Wu, 2005). Managers of poorly governed firms are likely to engage in corrupt activities with bureaucrats and politicians who seek private gains by using their positions and power. In other words, if there is a demand side for corruption, there will be corruptible firms and managers engaging in such activities on the supply side. The practice of corruption has socioeconomic roots and manifests itself in different forms and levels across societies (Pena López & Sánchez Santos, 2014). Not only bribery prevails, but also nepotistic appointments, the diversion of public funds for the benefit of particular elites, favoritism in procurements, or accessing private information of citizens held by the governments, etc.

For many managers in the developing countries, engaging in such controversial governance practices may not necessarily be considered as unethical, but could be regarded as part of their normal business activities, or merely a matter of survival (Crane et al., 2019). In contrast to a manager with western ethical values, a Sri Lankan manager could make a subjective and context-dependent moral judgement to the ethical business dilemmas (called *moral relativism* by Gowans, 2021). For instance, a manager may feel compelled to be more responsible toward his own ethnic communities rather than to invisible shareholders, and therefore find no reason to consider such nepotistic relations as corrupt or unlawful. Also, ethical values associated with the doctrines within one's religion may shape moral judgement and influence economic incentives (Weber, 1947). For instance, the Buddhist's ethical perspective, which is adhered to by the majority ethnic group (the Sinhala) in Sri Lanka and which values compassion, interconnectedness, and a web of relations, can lead to significantly different approaches and judgements when dealing with ethical dilemmas than western ethics (Gould, 1995). The history has also shown as that leaders' individual actions can also influence other people's ethical judgements, behavior, and economic preferences (Acemoglu & Jackson, 2015).

Despite of persistent concerns about corrupt and nepotistic relations, Sri Lanka has taken steps towards improving its corporate governance practices and converging towards global governance code of conducts. However, as we will point out, the socio-cultural norms and inter-personal relations may conflict with the rules of the global code of conduct. We observe that social norms sometimes conflict with legal norms in Sri Lanka, as also shown by Parsons (2010) in his historical analysis, of former British colonies such as India and Kenya.

Since the Asian financial crisis in 1997, corporate governance has attracted the attention of scholars and policymakers in the South Asia region (Claessens et al., 2000a, 2000b). Johnson et al. (2000a, 2000b) argue that, at the country level, the corporate governance regulations were more effective than the macroeconomic

[1] See Transparency International www.transparency.org for the up-to-date information about worldwide corruption.

measures in addressing the Asian crisis. Following the crisis, Sri Lanka introduced the country's first voluntary code of best practice (1997). In the last two decades, many firms in Sri Lanka adapted their corporate governance practices to align with international standards. Voluntary disclosure was recently replaced by more comprehensive and mandatory regulation: the Code of Best Practice on Corporate Governance (2017). However, there is no evidence of that such developments on the supply side have improved the country's position on the worldwide corruption and governance indices. Sri Lankan shareholders and stakeholders suffer from insufficient enforcement mechanisms, such as time lags in regulatory and judicial decision-making (the rule of law), and pervasive political interference.

As a comprehensive corporate governance review that addresses various agency problems in Sri Lanka firms is missing, we aim to fill this gap in and provide descriptive analyses by means of the most up-to-date corporate governance data on listed companies. In particular, we try to understand how the unique institutional and social characteristics of the country relate to its most important corporate governance issues such as ownership and control, shareholder and creditor protection, the role of banks, and stakeholder management. We will also elaborate on the sources of main agency problems in Sri Lanka and discuss how the associated costs can be mitigated.

Similar to firms in many Asian countries (see Holderness, 2009), Sri Lankan firms exhibit a concentrated ownership structure which creates typical (Asian-style) agency problems: These are conflicts of interest between (i) minority and majority shareholders, (ii) shareholders and debtholders, and (iii) shareholders and stakeholders. These agency problems are different from the traditional agency problem between managers and shareholders that we usually observe in Anglo-American corporations (Jensen & Meckling, 1976). The main agency problem in the rest of the world largely originates from the conflicts of interest between the few large shareholders and minority shareholders (Claessens et al., 2000a, 2000b). Furthermore, our analysis will indicate that both external and internal monitoring mechanisms, such as the external audit system, board monitoring, and corporate governance compliance are insufficient to mitigate these agency conflicts among corporate players.

We argue that today's corporate governance issues in Sri Lanka are not independent of the country's institutional background and cultural, religious and ethno-linguistic social intricacies. The country's legal and institutional framework were originally shaped by colonial powers, mainly the Dutch and British rulers. Since then, Sri Lanka has performed legal and constitutional reforms, starting with the Anglo-Saxon common law legal tradition that it had adopted at the end of the nineteenth century. Although the country has recently taken important steps to improve the protection of shareholder and creditor rights, corporate governance enforcement and reform strategies have been largely unsuccessful because of persistent economic and political instability. Sri Lanka has failed to build inclusive and well-functioning institutions, constrain its political elites, and distribute political power homogeneously across ethnic groups. As a result, political power has accumulated among some Sinhala-Buddhist elites who control a majority of state organizations as well as corporations. As discussed later, not only the country's institutions but also its highly fractured and complex ethno-linguistic structures play a vital role in the functioning of corporations and in the ways people work and cooperate in Sri Lanka (Widger, 2016). The country was torn apart by the long-lasting civil war and suffered from fatal racism that even led to genocide.[2] Over the past decade, enhancing diversity and inclusion at the board level and on the work floor has been one of the most important corporate governance objectives of Sri Lankan corporations.

The most prevalent agency problem in Sri Lanka is no different from what is often observed in other Asian countries (Goergen, 2018): expropriation of minority shareholders' rights. Many business groups, families, and institutional investors control large firms by means of ownership pyramids, cross-holdings, or intermediate private firms (Mapitiya et al., 2016). The ownership structure in Sri Lanka is typically opaque and complex as (1) it is hard to identify the ultimate owners of firms within business groups, (2) many listed firms are controlled by private firms whose ownership structure is opaque, and (3) single shareholders (e.g. families) can own up to 80% of the equity of listed firms. Usually, agency costs are borne by minority shareholders via tunneling, transfer pricing, nepotism, and infighting (Johnson et al., 2000a, 2000b; Levine et al., 1997). Given the differences between agency problems between Anglo-American and Sri Lankan firms, standard corporate governance practices in western companies may not mitigate agency conflicts in Sri Lanka. One typical Sri Lankan issue is associated with the existence of family firms. These firms often appoint family members or friends from their network as CEO and as other executives and non-executive directors, even if those people are not the best skilled to assume these roles. Accordingly, board independence is limited, monitoring power is weakened, and firms may lose growth opportunities as a result of this suboptimal allocation of human capital.[3]

The second agency problem in Sri Lanka typically arises between lenders and shareholders as lender-governance conflicts can negatively affect corporate performance (Ekanayake et al., 2019). Banks play a major role as the primary provider of capital. Conflicts of interest between debtholders and shareholders manifest themselves in many different forms. For example, firms may discard positive NPV projects if the debtholders capture most of the potential benefits of the project, or invest in overly risky or short-term projects with quick pay-off (this could lead to the typical debt overhang problem of Myers and Majluf (1984)). In some cases, managers pursue their personal benefits by continuing to operate the firm even if its liquidation value exceeds the market value.

[2] The Prevention of Terrorism Act created in 1979 unrest among ethnic minorities and escalated into a long-lasting violent conflict. As the response of Liberation Tigers of Tamil Elam (LTTE)'s militant attacks, many nationalist Sinhalese joined mobbing and killing of Tamils across the country in July 1983; this incident is known as *Black July*. The resistance sparked a 30-year long ethnic war between the LTTE and the Sri Lankan government. Both the LTTE and the pro-Sinhalese government army suffered many casualties.

[3] In Sri Lanka, board independence of family firms is weaker, and the CEO is mostly from the controlling family (Ahmed et al., 2016).

Sri Lanka is a bank-based economy, banks have significant monitoring power over firms.[4] They play an important role in reducing asymmetric information, mitigating conflicts of interest between shareholders and managers, and providing advice to firms, in spite of their limited ability to address the main agency problem (minority versus majority shareholders). Although the current creditor protection laws can to some extent limit the expropriation of the debtholders' rights by shareholders, firms' widespread use of political connections can force banks to accept wealth transfers to companies by granting credit at favorable terms. This particularly happens by state-owned commercial banks, which suffer from political appointments at the top leadership positions. Ekanayake (2018) claims that the corporate governance mechanisms of a state-owned commercial bank deteriorate due to frequent political interference.

In Sri Lanka, the internal audit mechanism does not guarantee good corporate governance. An initial problem, disclosed by the Securities and Exchange Commission (SEC) of Sri Lanka, is that internal audit committees are frequently still lacking (they are present in only 62% of firms). Even if an audit committee is present, the independence of some committees is doubtful, as the committee's chair is not an independent non-executive director in 25% of the cases, and in 9% of firms the CEO also holds the position of chairman. Every firm needs to hire an external auditor to verify the books to prevent fraud. It is however not clear whether firms gain from such external monitoring by their auditors. The country's audit practice does not show evidence of the best practices of audit professionalism because of a high degree of corruption, persistent political involvement in the firms, and abuse of power (Yapa et al., 2017). It is also argued that external audit firms—dominated by the Big-Four[5] players—hamper the development of competitive auditing market. Evidence shows that external auditing firms have had little power to prevent major national corporate scandals (e.g. the *Pramuka Bank* scandal), and tend to present subjective judgments about the firm's financial position to please their customer-firms. For instance, Abeysinghe (2015) reports that the depositors of the *Pramuka Bank* claimed Rs. 6 billion from its auditors (KPMG) following the lack of disclosure of the bank's financial distress.

There is mixed evidence on the monitoring role of corporate boards in Sri Lanka considering the political connections of directors (Berkman & Galpoththage, 2016), the contribution of outside directors (Azeez, 2015), and diversity and inclusion on the board (Nazliben et al., 2022; Wellalage & Locke, 2013). According to the corporate governance code of 2017, firms are obliged to ensure board independence: one third of the directors of (one-tier) boards, must be non-executive directors (NEDs). However, to what extent the NEDs are really independent is questionable because many NEDs

[4] Sri Lankan firms are highly leveraged as total debt represent 81% of total assets. Long-term borrowing often consist of bank borrowings, as the corporate debenture market is still underdeveloped. Besides, over the last decade, bank borrowings of the private sector amounts to about 50% of GDP. Perera (2010) reports that Sri Lankan firms use the following financial resources: bank lending (57%), equity (22%), government bonds (20%), and corporate bonds (1%).

[5] Deloitte (SJMS), Ernst & Young (EY), PricewaterhouseCoopers (PwC), and Klynveld Peat Marwick Goerdeler (KPMG).

usually belong to controlling families' networks or to people with strong connections with the government (e.g. top government officials). Political bodies may extract corporate resources (e.g., through requiring corporate donations or demanding that employees vote for their political parties or political candidates). Also, directors may use their political ties to gain (e.g. through winning the procurement of the government's development investments). In particular, we observe that many CEOs who are from the country's dominant ethnic background, Sinhalese-Buddhist, have important political connections. Besides, insufficient board heterogeneity among Sri Lankan firms negatively affects the monitoring power of corporate boards and corporate performance. We observe that the ethnic demography of the country is not been well represented at firms' top management level as a consequence of ethno-linguistic and religious conflicts and the dominant macho culture in society. Nazliben et al. (2022) show that ignoring diversity is costly for the Sri Lankan firms. The firms that ignore diversity and inclusion in their corporate boards pay a significant cost, in that poorly diversified board perform poorly and suffer from financial instability relative to peers that are more inclusive.

Stakeholder-shareholder conflicts constitute the third form of agency problems in Sri Lanka. Poor stakeholder management and corporate social responsibility (CSR) seem to be a widespread issue. Although the country has taken important steps towards more equitable labor rights over the past decades, several organizations (e.g., International Trade Union Confederation, Solidarity Center, etc.) indicate violations of employees' rights, illegal working conditions, ethnic discrimination, and child labor. Weerasinghe and Ajward (2017) highlight that management is less likely to consult stakeholders when formulating corporate governance policies and practices. Fernando et al. (2015) claim that local (even large) companies are less attentive to natural environmental governance compared to their foreign counterparts. When local firms engage in environmental activities, they seem to predominantly do so for marketing or image building purposes. Furthermore, disclosure on the impact of corporate decisions on environmental, social, and governance (ESG) issues is lacking or unreliable. Besides, the market for socially responsible investment (SRI) funds and impact funds is still underdeveloped. Consequently, shareholder activism on ESG is lacking. With exception of ESG funds in India (e.g., SBI Magnum Equity ESG Fund, ESG Exchange Traded Fund, etc.), SRI does not seem a priority in other parts of South Asia.

The rest of the paper is structured as follows. In the next section, we discuss the institutional background of corporate governance, followed by a section on ownership and control. In the fourth section, we elaborate on the role of banks. In Sect. 5, we report board structure and managerial behavior. In Sects. 6, 7, and 8, we discuss the market for corporate control, corporate social responsibility, and lessons from corporate governance failures respectively. In the final section, we draw conclusions and propose research agenda.

## 2 Institutional background

We discuss how the evolution of public governance and the legal tradition has contributed to the development of corporate governance. We then deliberate on reform strategies and milestones of corporate governance implementation while taking into account the economic and political context.

### 2.1 The evolution of governance and legal tradition

Sri Lanka's governance tradition has evolved from the *Ceylon* Kingdom's ruling system, which for centuries regulated basic economic activities and individuals' behavior in society. When the first Sinhalese king (prince *Wijaya*) came from Sinhapura (India) to Sri Lanka in 543 BCE, the new ruler introduced a king-based government system that incorporated the Indian tradition of governance. In the *Ceylon* Kingdom, religion played a very important role; the monitoring of public governance took place from Buddhist temples and Buddhist monks had an advisory role in state administration. The palace extracted considerable economic wealth from society.[6] As the kingdom organized the delegation of power in a hierarchical way with the appointment of leaders of a region, area, or village (e.g., a village leader is called *Gamika*, and a city leader *Nagara Guththika*) who were responsible for spreading and organizing the king's orders, crime investigations, grievance handling, issuing permits for accessing lands, etc. In ancient Ceylon (815–1017 AD), accounting and auditing practices were introduced based on simple accounting methods rather than double-entry bookkeeping (Liyanarachchi, 2009, 2015).

During the colonization period (1505–1948 AD), Sri Lanka adopted western-style institutional practices and legal frameworks. Colonization prevailed for about 450 years, starting with the Portuguese (from 1505 AD), followed by the Dutch (from 1660 AD) and the British (from 1815 AD). Acemoglu and Robinson (2012) state that the prosperity of the Indian subcontinent attracted the attention of western colonial powers more than the other parts of Asia. As a result of the competition of colonial forces, Sri Lanka was affected by several institutional traditions which created its own local legal context. Roman-Dutch Law was enforced by the Dutch. Later, the British imported their common-law tradition (English legal origin).[7] Consequently, the British rulers (1796–1948 AD) introduced long-term economic policies and reforms and developed infrastructure, including the expansion of plantations for tea, coffee, and rubber. For the first time in *Ceylon*, the British rulers introduced some democratic elements along with legal developments in 1833. For

[6] The king's ruling system initiated division of labor among people by assigning certain economic activities (e.g., agriculture, animal husbandry, handicrafts, pottery, metal-work, clay work, etc.) that addressed the palace's needs. Based on economic activities, people were divided into different casts (as reflected in their surnames). Within these communities, equal distribution of income, an exchange-based society, and the maximum utilization of resources were ensured.

[7] According to La Porta et al. (1998), commercial laws have originated from two traditions namely Common Law (English law origin), and Civil Law (Roman law origin). The British have imposed Common Law as the commercial law across the British colonies.

instance, the Joint Stock Companies Ordinance (1861) and Joint Business Establishments[8] allowed business entities to be registered under the Registrar General's Department and to find new financing sources (such as public funds through equity issuance).[9] Introduction of Prevention of Frauds Ordinance No. 7 of 1840 was a milestone of public governance, and thereinafter, major legal and constitutional reforms were occasionally introduced. In Table 1, we summarize such chronology of major legal and constitutional reforms and significant events which shaped the governance mechanisms of the country.

Sri Lanka (as well as India) adopted the English common law legal tradition that provides more protection of shareholders' rights (than civil law systems) (La Porta et al., 1998). The common law legal family hinges on a case-law based system in which judicial authorities make decisions based upon precedent cases and can make their own interpretations of the law. In contrast, the civil law legal family is based on extensive codes of laws, which define all contingencies with a large set of articles such that there is less room for interpretation of the law by judges. La Porta et al. (1998) stress that the common law countries are much more flexible and efficient and therefore are in harmony with market-based economies. Conversely, they insist that the quality of law enforcement is lower in common-law countries than in Scandinavian and German civil-law countries. Appendix 1 shows the rule of law index, an indicator of law enforcement, which ranges from − 2.5 (weak) to + 2.5 (strong) and is based on contract enforcement, the degree to which property rights are upheld, and the judicial system. The index score was 0.04 for Sri Lanka in 2021, a mild increase after a sharp decline in 2020. Comparing the quality of the rule of law in Sri Lanka with the scores for the sample countries, we observe that the quality is lower in Sri Lanka, which may have repercussions on attracting international investors.

Since the independence in 1948, efforts to build inclusive and well-functioning institutions have been hampered by the evolution of the political landscape. As the politicians try to extract more benefits from the economic system, firms feel the need to create tighter connections with the political class. Close political connections are particularly important in state-owned enterprises and in private sector firms that engage in large-scale government-paid development projects. Firms with high "political capital" are able to adjust the government's economic and financial policies to their own benefit. The regulatory bodies of the state and enforcement agencies function poorly as a result of the high degree of politicization (Balasooriya et al., 2008). Sri Lanka's score on the regulatory quality index (which ranges from

[8] This is a business arrangement where two individuals or two firms jointly formed an establishment by sharing values and resources.

[9] Under British colonial rule, Joint Stock Companies Ordinance (1861) assigned the responsibility of registering companies to the Registrar General's Department which felt under the Secretary-General of the British Colonies. This was merely a re-registration because companies had already registered in Britain for undertaking businesses. However, the ordinance intended to develop companies' affaires and stimulated the funding of agricultural cultivations. Following a coffee blight, the coffee planters shifted to tea production which required a higher initial capital. Joint Business Establishments were established to provide required capital for such projects via equity financing (share issuance to the public).

**Table 1** Chronology of legal and constitutional reforms

| Year | Event | Remarks |
|---|---|---|
| 1840 | Crown Lands (Encroachments) Ordinance No. 12 of 1840 | The British introduced this ordinance to prevent encroachments. All lands were treated as crown lands to which people failed to prove their ownership |
| 1890 | Partnership Act of 1890 | Provisions for the rights and duties of individuals or entities who conduct businesses in partnership |
| 1896 | Inception of share trading | Limited liability companies engaged in the plantation sector commenced share trading under the Colombo Share Brokers Association |
| 1923 | Indian Immigrant Labor Ordinance No. 01 of 1923 | Establishment of the Department of Indian Immigrant Labor which was responsible for administering the rights of Indian immigrants |
| 1923 | Local Treasury Bills Ordinance No. 8 of 1923 | Provisions for borrowing money for the government by issuing treasury bills |
| 1931 | *Donoughmore* Commission | Commission to create the *Donoughmore* constitution which dealt with multi-ethnic problems preventing the political dominance by single ethnicity |
| 1931 | *Bracegirdle* embarrassment | *Mark Bracegirdle*, an Australian estate superintendent, took leadership to protect labor rights opposing British planters. This incident, called *Bracegirdle* embarrassment, provided a foundation for labor law |
| 1934 | Workmen's Compensation Ordinance No.19 of 1934 | Provisions were made for paying compensation to workmen (employed persons whose wage did not exceed Rs. 500 per month) who got injured when employed |
| 1935 | Trade Unions Ordinance No. 14 of 1935 | Ordinance covering employees' freedom to unionize, rights of collective bargaining, and industrial relations |
| 1937 | Registered Stock and Securities Ordinance No. 7 of 1937 | Provisions for issuing registered stocks, government promissory notes, bearer bonds, and treasury bonds |
| 1938 | Company Ordinance No 51 of 1938 | Establishment of the Department of Registrar of Companies to which the duty of registering companies was transferred from the Registrar General's Department which fell under the Secretary-General of the British Colonies |
| 1939 | Maternity Benefits Ordinance No.32 of 1939 | Provisions for maternity benefits of women workers including maternity leave, payment conditions, and childcare facilities |
| 1941 | Wages Boards Ordinance No.27 of 1941 | Regulation of wages and other payments of employees through the establishment of wage boards which comprise the labor commissioner, nominated members, and representatives of the employer and workers |

**Table 1** (continued)

| Year | Event | Remarks |
|---|---|---|
| 1942 | Second world war | British Ceylon was one of the military bases of the British against Japan during WWII. In 1942, Japan bombed Colombo, the country's commercial hub |
| 1944 | *Soulbury* Commission | Lord Soulbury was sent to British Ceylon by the British government to study a constitutional draft and to give recommendations for a new constitution |
| 1948 | *Soulbury* Constitution | The country gained independence under the new constitution and received joined the Commonwealth of Nations which shared a monarch with the other commonwealth nations (i.e., the Dominion status of British Ceylon) |
| 1949 | Appointment of First Native Prime Minister | The first native prime minister, *D.S. Senanayake*, was elected. He was the leader of the constitutionalists in independent Ceylon |
| 1949 | Monetary Law Act No. 58 of 1949 | Provisions to establish the financial system and the Central Bank (CB), and to confer the CB's Monetary Board powers, functions, and responsibilities to regulate the financial system |
| 1950 | Industrial Dispute Act No. 43 of 1950 | Provisions for the prevention of industrial disputes, and guidance for settlement of reported disputes through investigations |
| 1953 | Exchange Control Act No. 24 of 1953 | Provisions to authorize the Central Bank for administering currency, securities, debts, gold, payments, and foreign trades |
| 1954 | Shop and Office Employees Act No. 19 of 1954 | Regulation on employment, working hours, wages, leaves, and health and comfort of employees in shops and offices |
| 1956 | Employment of Women, Young Persons, and Children Act No.47 of 1956 | Provisions for the prevention of child labor and fair treatment and equal opportunities for women in employment |
| 1956 | The Official Language Act No.33 of 1956 | Declaration making the *Sinhala* language as the language of commerce and education. This led to a division between Sinhalese and Tamils and stimulated racially-based unrest |
| 1957 | Nationalization of Privately-owned businesses | Transport services, insurance, petroleum, ports, and estates were nationalized |
| 1958 | Employees' Provident Fund Act No 15 of 1958 | Establishment of a provident fund for employees in public and private sectors to grant benefits at retirement |

**Table 1** (continued)

| Year | Event | Remarks |
|---|---|---|
| 1971 | Termination of Employment of Workmen Act No.45 of 1971 | Special provisions for implementing the termination of certain employment contracts of workmen |
| 1971 | 1971 Revolt | JVP (a political party) launched an insurrection to seize power, which resulted in approximately 10,000 youth deaths |
| 1972 | Republican Constitution | This granted the country the designation, Republic of Sri Lanka. Hereinafter, the economy adopted closed economic status in which state-owned enterprises commenced commercial activities |
| 1977 | Economic Liberalization | An open economic system replaced state capitalism. A liberal economic democratic model was established which attracted foreign direct investments through the *Greater Colombo Economic Commission* |
| 1978 | 1978 Constitution | Creation of a unicameral parliament, appointment of an executive president, independent judiciary, and protection of fundamental rights |
| 1979 | Prevention of Terrorism *Act* No. 48 of 1979 | Temporary provisions for avoiding illegal actions of any person, group of people, or any form of association |
| 1982 | Companies Act No. 17 of 1982 | Companies act covering aspects from incorporation to winding-up |
| 1983 | *Black July* (Civil War starts) | Sinhalese attacked Tamils as a result of the killing of army soldiers by the Liberation Tigers of Tamil Elam (LTTE). The ethnic war started |
| 1983 | Payment of Gratuity Act No.12 of 1983 | Provisions for paying a retirement gratuity to workmen for the period of services rendered |
| 1984 | Establishment of a public trading floor | Colombo Brokers Association established a public trading floor and commenced trading on the "open outcry system" |
| 1985 | Establishment of Colombo Securities Exchange | Establishment of Colombo Securities Exchange by Colombo Share Brokers Association jointly with Colombo Brokers' Association which was engaging in auctioning land shares |
| 1987 | Business Names Ordinance No. 7 of 1987 | Provisions to register firms and individuals who conduct businesses under business names |

**Table 1** (continued)

| Year | Event | Remarks |
|---|---|---|
| 1987 | Securities Council Act No. 36 of 1987 | Establishment of the Securities and Exchange Commission to regulate the securities market such as licensing stock exchanges, brokering firms, dealers, and any intermediary |
| 1988 | Banking Act No. 30 of 1988 | Provisions for licensing banking business and for regulating and controlling bank operations |
| 1995 | Sri Lanka Accounting and Auditing Standard Act No. 15 of 1995 | Adopting Sri Lanka accounting and auditing standards and the establishment of Sri Lanka Accounting Standard Monitoring Board |
| 2000 | Finance Leasing Act No. 56 of 2000 | Provisions to regulate finance leasing businesses including rights and duties of lessors, lessees, and suppliers of equipment |
| 2005 | Payment and Settlement Systems Act No. 28 of 2005 | Provisions on 1) regulation of payment, clearing, and settlement systems; 2) disposition of securities on the Central Bank's books; 3) regulation of providers of money services; 4) facilitation the electronic presentment of cheques |
| 2006 | Financial Transactions Reporting Act No. 6 of 2006 | Provisions to collect data on suspicious financial transactions for preventing offences of money laundering and financing of terrorism |
| 2007 | Companies Act No. 7 of 2007 | Provisions on incorporation, accounting and reporting requirements, winding up of companies registered in Sri Lanka |
| 2009 | National Institute of Occupational Safety and Health Act No. 38 of 2009 | Provisions to formulate a policy on work-related safety and health standards and to create environment for protecting safety and health of both employers and employees |
| 2009 | Civil war ends | Civil war between LTTE and the Sri Lankan government officially ended after 26 years |
| 2011 | Finance Business Act No. 42 of 2011 | Provisions to license and regulate business entities that carry out finance businesses including accepting deposits |
| 2015 | 19th Amendment to the 1978 Constitution | Dilution of many executive powers held by the Executive President including a decrease of presidential term from 6 to 5 years |
| 2016 | Micro Finance Act No. 6 of 2016 | Provisions to license and regulate microfinance businesses by the Central Bank and its monetary board |
| 2017 | Foreign Exchange Act No. 12 of 2017 | Provisions to promote and regulate foreign exchange and to vest its responsibility in the Central Bank |

**Table 1** (continued)

| Year | Event | Remarks |
|---|---|---|
| 2018 | Active Liability Management Act No. 8 of 2018 | Provisions to authorize raising loans inside or outside the country for improving public debt management via active liability management |
| 2019 | Moor extremists attack | Easter Sunday bombings by Moor extremists called National Thowheeth Jama'ath (a religious organization) |
| 2020 | 20th Amendment to the 1978 Constitution | A reversal of the 19th Amendment to the Constitution, which again enhances executive powers of the president while weakening powers of the Prime Minister's office and the cabinet |
| 2021 | Securities and Exchange Commission Act No. 19 of 2021 | Establishment of Securities and Exchange Commission through which to regulate market institutions, issuance of securities, and market intermediaries, and to protect investors |

*Sources* International Labor Organization, Department of Labor, Ministry of Justice, Central Bank of Sri Lanka

This table presents major legal and constitutional reforms for businesses, shareholders, employees, and the general public during colonization and onwards, as well as some dates related to the civil war and terrorist attacks a weak − 2.5 to a strong + 2.5 and measures the government's effectiveness in setting policies and regulations to encourage private sector development) is negative (−0.37) and the lowest within the countries from Asian emerging markets (Appendix 1).

While legal and regulatory reforms could have led to better governance mechanisms, civil wars have seriously damaged the country's economy. The three-decade civil war between Tamil Tigers (LTTE) and the (Sinhalese) government created an unstable business and investment environment. Uncertainty permeated the whole economy and negatively affected stock market value[10] and international trade. Many industries, such as tourism, airlines, public transport, as well as the economic and financial centers were hit hard.[11] The political stability index, which ranges from a week − 2.5 to a strong + 2.5, was negative for Sri Lanka for nearly three-decades, turned positive during 2015 and 2016, but has become negative again since 2017 because of outbursts of politically-motivated violence and terrorism, and declined as the result of the recent political and humanitarian crisis in 2022.

Problematic institutional and governance processes undermine international capital flows, financial market development, and growth prospects in Sri Lanka. Athukorala (2003) argues that the attractiveness of Sri Lanka to foreign firms is hindered by the absence of good governance, and by corruption, political instability, bureaucratic inertia, and poor law and order. Beck and Levine (2002) make a cross-country comparison of financial development and activity, measured by size and activity of the stock markets and banks, regulatory restrictions on banks, and the extent of state ownership of banks. They find that Sri Lanka imposes relatively few regulatory restrictions on banks' activities, but that the government owns a large share stake in the ten largest banks. Tunay and Yuksel (2017) report a strong relation between foreign bank operations and corporate governance in developing countries. The extent of foreign banks' presence in these countries is determined by poverty, corruption, political stability, and efficiency and flexibility of corporate regulation, which is valid for Sri Lanka. Some studies (e.g., Beck & Levine, 2002; Chakraborty & Ray, 2006; Levine, 2002; Srinivasan et al., 2011) find a long-run equilibrium relation and bidirectional causality between foreign direct investment (FDI) and economic growth. Sri Lanka receives insufficient FDI to sustain a high growth rate; the net inflow FDI is merely 0.90% of GDP.

Researchers have provided recommendations on how to achieve a better institutional and governance framework for Sri Lanka. Gunathilake et al. (2011) stress

[10] Kumara et al. (2014) examined volatility clustering in stock return during the ethnic conflict in Sri Lanka.

[11] Airports stopped operations, and airlines were forced to made additional security investments. Public transport and logistics systems suffered from continuous terrorist attacks. As the central bus terminal is the travel destination of long-distance buses, the impact of its demolishment in a terror attack proliferated throughout the country. The oil storage attack led to a large oil crisis in the country, which harmed the entire traveling and logistic systems. In 1997, a terror attack was made on the world trade center located in the twin 39-story towers where international firms as well as the SEC and the Colombo Stock Exchange (CSE) were located. Even after a decade of relative peace, there are occasional waves of hostility; e.g. the Easter Sunday bombing in 2019 of three luxury hotels by Islamic extremists.

that the rapid expansion in the corporate sector requires upgrading the existing regulatory system while mitigating the cost of compliance and encouraging access to equity capital. According to Jayasuriya (2008), effective law enforcement necessitates sufficient allocation of resources, capacity building of regulators, and international collaboration. Likewise, Mazhar and Goraya (2015) underline that good governance in South Asia needs to be strengthened to reach international standards and structures. Jamil et al. (2013) discuss governance trends in the region and emphasize the need to implement governance reforms requiring engagement by both civil society and the private sector, and reduce bureaucratic rigidity. From the development economics literature, Acemoglu and Johnson (2003) stress the importance of limiting the power of political and business elites of the country. Accordingly, while the country is reconstructing its political institutions, the corporate players should seek for a national consensus on implementing the global code of conduct. Whether these recommendations are sufficiently implemented is doubtful as it requires a performance-oriented civil service, political and managerial accountability, transparency of governmental and corporate actions, respect for democratic freedoms and citizenship rights, decentralization, and willingness of the ethnicities to share of power.

### 2.2 Shareholder and creditor protection

Protection of minority shareholders' rights is important, especially when a few investors hold sizable controlling stakes in corporations and even the whole economy (La Porta et al., 2000). The concentrated ownership held by families and the lack of minority rights protection are major governance problems in Asia (Claessens & Fan, 2002). Both the shareholder and minority shareholder protection indices of Sri Lanka are, however, moderate in comparison with the sample countries (see Appendix 2).

In the British-based common law legal system, the protection of creditors' rights is weaker than in civil law countries. La Porta et al.'s (1998) creditor rights index is lower when, in case a firm goes bankrupt, there is no automatic stay on assets,[12] the proceeds from the disposition of assets are not prioritized to the secured creditors, a minimum percentage of total capital is not mandatory for preventing a firm from dissolution.[13] When comparing creditors' rights across the countries (Appendix 2), we note Sri Lanka is one of the countries with weakest creditor protection because an efficient credit recording system is lacking, and the guaranteeing of secured debt with collateral and the payment priority rule in the event of liquidation are insufficiently upheld.

In addition to the legal protection of creditors and shareholders, legal enforcement mechanisms (the rule of law) are also important. Sri Lanka needs a stronger

[12] If the borrower is bankrupt, an automatic stay, which is an automatic injunction, prevents the creditor from collecting debt until the court activities (possibly involving a restructuring of claims) are finished.

[13] La Porta et al. (1998) define another creditor rights measure: legal reserve requirement, which requires firms to maintain some capital levels for preventing their automatic liquidation. As a result, creditors can force an automatic liquidation before the capital is wasted by insiders.

legal system for securing the rights of creditors and shareholders, which would lead to more foreign capital being invested in the country and hence higher economic growth. According to La Porta et al. (1997a), Sri Lanka is the weakest among English law countries to guarantee law and order, and the judicial system is only moderately efficient, but below the English-origin average. Perera (2010) confirms that the level of judicial enforcement in Sri Lanka is lower than that of the average of the Asian country sample.

### 2.3 Corporate governance reforms

As the British governed many South Asian countries during the colonization period, governance reforms of Sri Lanka are largely consistent with those of other South Asian countries. According to Haque (2001), the British colonial rule has contributed towards the evolution of a modern system of governance in the South Asian region (with exception of Nepal). For Sri Lanka, the governance reforms of India were particularly important because of (1) Sri Lanka's historical economic ties with India, (2) India still being one of the largest im/export destinations, and (3) Indian leadership in corporate governance reforms. Conversely, Ray (2009) argues that the Indian corporate governance code has evolved from a problematic governance system riddled with agency conflicts to a state-of-the-art system after integrating US GAAPs and IFRS.[14] Clarke (2015) surveys that amplified business growth and economic development of BRIC countries ("I" stands for India) was supported by improvements in governance practices and the better functioning of institutions. Firms in BRIC countries are often adhering to international best practices of corporate governance beyond the statutory requirements of local corporate governance codes (Lattemann, 2014). In line with the Companies Act of 2013, India has introduced a new corporate governance code which comprehensively requires accountability, transparency, and stringent disclosures, but the effectiveness is still hindered by ownership concentration (and the dominance of powerful families) and too low a level of enforcement and regulatory compliance (Kansil & Singh, 2018; Uzma, 2018).

While Sri Lanka experiences similar lapses in governance implementation as India, it has still taken important steps to strengthen the codes of best practices of corporate governance for public companies. In Table 2, we summarize the corporate governance regulations and reforms from 1997 onwards. In 1997, the Institute of Chartered Accountants of Sri Lanka (ICASL) released the first voluntary code of best practices which was based on the UK's *Cadbury Code (1992)*. This code covers key governance aspects such as board's structure, responsibilities, and functions; the roles of auditors; and shareholders' rights and duties. Accordingly, listed local and foreign firms were required to disclose information on corporate governance

[14] Qurashi (2018) is more sceptical and claims that Indian firms are less likely to converge with corporate governance guides of the UN (at only 50% of firms) compared to firms in Pakistan (77%), and Bangladesh (77%).

**Table 2** Corporate governance reforms

| Year | Corporate governance regulations and reforms |
|---|---|
| 1997 | Code of Best Practice on matters related to financial aspects of Corporate Governance (first edition) issues by the Institute of Chartered Accountants of Sri Lanka (ICASL) |
| 2001 | Handbook on Corporate Governance: Principles and Guidelines to Best Practice in Sri Lanka |
| 2002 | The Code of Best Practice on Audit Committees (special edition) issued by the Institute of Chartered Accountants of Sri Lanka |
| 2002 | Code of corporate governance for banks and other financial institutions issued by the Central Bank |
| 2003 | Code of conduct for the primary dealers dealing in government securities issued by the Central Bank |
| 2003 | Code of Best Practices in Corporate Governance for Public Enterprises in Sri Lanka issued by the Department of Public Enterprises of the Ministry of Finance |
| 2003 | Code of Best Practice Corporate Governance (second edition) issued jointly by Institute of Chartered Accountants of Sri Lanka and Securities and Exchange Commission of Sri Lanka |
| 2004 | Guidelines for Listed Companies on Audit and Audit Committees issued by the Securities and Exchange Commission of Sri Lanka |
| 2007 | Incorporation of corporate governance into the listing rules by the Colombo Stock Exchange |
| 2007 | The Central Bank issued Banking Act Directions No. 11 and 12 of 2007, which include mandatory rules of corporate governance for banking sector |
| 2008 | Code of Best Practice on Corporate Governance (third edition) issued jointly by Institute of Chartered Accountants of Sri Lanka and Securities and Exchange Commission of Sri Lanka |
| 2008 | Guidelines for the appointment of auditors of listed companies issued by the Securities and Exchange Commission of Sri Lanka |
| 2008 | Finance Companies (Corporate Governance) Direction No. 3 of 2008 issued by the Central Bank |
| 2009 | Finance Leasing (Corporate Governance) Direction No. 4 of 2009 issued by the Central Bank |
| 2013 | Code of Best Practice on Corporate Governance (fourth edition) issued jointly by Institute of Chartered Accountants of Sri Lanka and Securities and Exchange Commission of Sri Lanka |
| 2017 | Code of Best Practice on Corporate Governance (fifth edition) issued jointly by Institute of Chartered Accountants of Sri Lanka and Securities and Exchange Commission of Sri Lanka |
| 2018 | Direction No. 17: Corporate Governance Framework for Insurers issued by Insurance Regulatory Commission of Sri Lanka |

*Sources* Institute of Chartered Accountants of Sri Lanka, Securities of Exchange Commission of Sri Lanka, Government Treasury, Central Bank of Sri Lanka

The most recent version of Sri Lanka's constitution can be found in the document released by the parliament of Sri Lanka with the title of "The constitution of the Democratic Republic of Sri Lanka, Revised edition 2021"(Sri Lanka Parliament Secretariat, 2021). This table presents major reforms of corporate governance practices in the country including corporate governance codification processes, and compliance requirements

compliance in their annual reports.[15] In addition, in order to stimulate the creation of internal audit committees and define their scope and functions, the Code of Best Practice on Audit Committee (2002) was released. In 2004, the SEC provided a

[15] Many foreign companies are operating in Sri Lanka, but only few have listed in the Colombo Stock Exchange. For instance, from India: Lanka India Oil Corporation, PGP Glass Ceylon; from Japan: Expolanka Holdings; from Malaysia: Shalimar (Malay), Indo-Malay, Bukit Darah; from Switzerland: Nestle Lanka, from the UK: Ceylon Tobacco Company, etc.

comprehensive guideline for auditing and audit committees. Although the adoption of this guideline was voluntary, the majority of the listed firms complied.[16]

The Central Bank of Sri Lanka (CBSL) has made many reforms since the release of the first corporate governance code of best practice. Emphasizing the need to provide the release of truthful information to financial investors and customers, the CBSL introduced: (1) a code of corporate governance for banks and other financial institutions, and (2) a code of conduct for the primary dealers dealing in government securities.[17] Replacing the existing corporate governance code of 1997, the ICASL and SEC jointly released the Code of Best Practice on Corporate Governance in 2003. Senaratne and Gunaratne (2008) argue that this code predominantly followed the UK combined code (*Hampel code*)[18] of 1998. Sri Lanka has moved towards the Anglo-American model of corporate governance (Reed, 2002) by adopting a UK-based corporate governance system because of the (1) colonial relationship with the UK, (2) the common (English) legal tradition in Sri Lanka, (3) the connection with the Institute of Chartered Accountants of England and Wales (ICAEW), and (4) pressure from international donor agencies (e.g. IMF, Worldbank, etc.). For further details on the relation between the UK's and Sri Lanka's code of conduct, we refer to Gunetilleke (2009) and Senaratne and Gunaratne (2008). According to Mitchell and Wee (2004), Asian countries should not just have copied the UK corporate governance codes but should have found inspiration in the corporate governance models developed by the *OECD*,[19] the US, and Japan to ensure that their corporate governance codes reflect their corporate landscapes, which may be very different from that of the UK.

In the wake of the 2007–2008 global financial crisis, the voluntary corporate governance code was replaced by a mandatory code. The ICASL and the SEC jointly published the Code of Best Practice on Corporate Governance of 2008, which was inspired by several foreign corporate governance codes.[20] The 2008 corporate governance code was incorporated into the listing rules of the CSE, and hence, corporate governance disclosure was mandatory for all listed companies. Accordingly,

[16] The SEC (2005) surveyed whether audit committee recommendations were adopted by the 132 listed companies. 62% of these firms established an audit committee, of which 85% included independent non-executive directors. The chairman of the audit committee was an independent non-executive director in 75% of the audit committees. The board's and the audit committee's chairman was the same person in only 9% of the cases.

[17] Primary dealers are expected to maintain adequate documentation on the identity of customers throughout a business deal (Jayasuriya, 2008).

[18] Findings of the Cadbury code and the Greenbury code (which set standards for recognizing and accounting directors' remuneration) were incorporated into the *Hampel code* (1998).

[19] The Organization for Economic Co-operation and Development (OECD) disclosed its principles of corporate governance in 1999.

[20] The corporate governance code was based on the Combined Code (UK), the New York Stock Exchange Code (US), the Code on Corporate Governance of Singapore, the Principles for Good Governance and Best Practice Recommendations of the Australian Stock Exchange, the Malaysian Code on Corporate Governance, and the Corporate Governance Report of the Securities and Exchange Board of India.

firms violating listing rules are put on the "Watch List" of the stock exchange. The India example shows that severe penalties for non-compliance are effective: Indian firms' compliance to mandatory corporate governance disclosure has increased significantly (Abraham et al., 2015). The CBSL also further strengthened public accountability and transparency of financial intermediaries and released a mandatory corporate governance code for licensed commercial banks in 2008. This bank regulation embedded comprehensive guidelines on the responsibilities and composition of boards, assessed aptness and propriety of directors, defined the managerial functions delegated by the board, as well as the roles of the chairman and CEO, required the creation of board committees, and demanded the disclosure of related party transactions. In 2011, the Sri Lankan accounting profession moved towards adopting international accounting standards. The international orientation of chartered accountants has had a big impact on the (non)financial disclosure. Similarly, Sri Lankan firms have more recently displayed a tendency to implement sustainability reporting practices following the integrated reporting framework introduced by the International Integrated Reporting Council (IIRC) and Global Reporting Initiative (GRI). A cross-country comparison of GRI adoption reveals that Sri Lanka is showing a steady growth in GRI reporting and has the highest relative number of GRI as well as IIRC reports compared to India and Bangladesh (Global Reporting Initiative, 2020). The increase in the adoption of integrated reporting by Sri Lankan firms is also due to the fact that many state universities that offer accounting degrees have incorporated integrated reporting into their syllabi following isomorphic institutional pressures (Seneratne et al., 2022). KPMG (2020) documents that Sri Lanka, South Africa and Japan are only the three countries in which a majority of firms is practicing integrated reporting, but the sustainability reporting rate of Sri Lanka (66%) is still lower than the global average (77%).

In 2013, the ICASL and the SEC revised the existing corporate governance code, aligning it with the aforesaid codes. This code introduced some new aspects such as internal control, risk management, responsibilities of the audit committee and the board, reporting requirements of the remuneration committee, the role of company secretary in corporate governance, communication with shareholders, major and material transactions including related parties, and sustainability reporting (ICASL, 2013). In 2017, some more adjusted were done to the corporate governance code (ICASL, 2017).[21] Mitigating agency problems among corporations was the primary concern of this new codification process. Both horizontal (controlling owners vs. minority shareholders) and vertical (managers vs. shareholders) aspects of agency problems were addressed.[22] In spite of all these efforts to develop a comprehensive

[21] The governance committee included representatives of the SEC, CSE, CBSL, Insurance Board, Registrar of Companies, Sri Lanka Accounting and Auditing Standards Monitoring Board, as well as representatives of public listed companies, Institute of Directors, corporate lawyers, practicing accountants, and ICASL council (Chartered Accountants of Sri Lanka, 2017).

[22] Horizontal agency problems were addressed in the articles on the board and its composition, nomination and election of independent directors, determinants of independence, related party committees, approvals and disclosures, independent audits, and regulations for minority protection. Articles on vertical agency problems covered the board's role, devolution of powers to execute strategy, succession planning, guidelines for performance-based pay, remuneration committees, disclosure and claw-back provi-

corporate governance code, Peters et al. (2011) remained skeptical about the applicability of (global) corporate governance codes to developing and emerging markets.

Although corporate governance reforms only apply to listed corporations, private firms, state owned enterprises, microfinance institutions, and NGOs often also voluntarily adopt some of the governance practices. Still, the Department of Public Enterprises introduced a separate corporate governance code for (semi) state owned public enterprises and statutory boards in 2003, which aims at better assuring accountability and transparency, boardroom practices, and internal controls. The IMF has also propagated that Sri Lanka needs to improve the governance of state-owned enterprises and to assure public sector transparency in order to mitigate governance vulnerabilities (IMF, 2022). While private firms mostly do not publish annual reports, they still sometimes disclose their ESG perspective in sustainability reports. For instance, *Brandix Holdings*[23] is the single biggest apparel exporter of Sri Lanka, which annually publishes a sustainability report on its ESG practices and GRI compliance. Its reporting on the governance (G) factor includes its employee code of conduct, anti-corruption policy, vendor code of ethics, and various other compliance charters. *Unilever Sri Lanka Limited* is one of the biggest consumer goods companies fully owned by the British Unilever company. Although the company is not listed, it also discloses ESG practices focusing "Planet & Society", the issues that are expected to contribute to a fairer and socially inclusive world particularly through equitability, diversity and inclusion, responsible business conducts, and respect for human rights.

## 3 Ownership and control

The characteristics of corporate control in Sri Lanka are similar to those frequently observed in other Asian countries: large shareholders control firms by means of control pyramids and cross-holdings.[24] Table 3 reports summary statistics of ownership structures and control for listed firms. The equity ownership of stock corporations can be classified into individual/family shareholders and institutional/state/corporate

Footnote 22 (continued)

sions, codes of ethics, related party provisions, and well contracts of employment. In addition, effective board practices require adaptive business strategies and risk management, competent execution, good governance and ethics, accountability, transparency, probity, stakeholder inclusivity, economic sustainability, and environmental responsibility.

[23] Although *Brandix* is a private equity firm, its economic contribution is overlooking. Company employs more than 50,000 people from Sri Lanka, India, and Bangladesh out of which Sri Lanka gives the highest contribution (around 35,000 employees). It annually generates more than $600 million turnover with considerable foreign currency flow.

[24] In Japan, corporations are part of business structures called "*Keiretsu*", which are essentially a network of companies related by ownership links. Horizontal Keiretsu form an alliance of cross-holding firms which have close ties with a bank that provides financial services to the alliance. In Korea, large business groups controlled by an individual or family are called "*Chaebol*". Chiang (2017) reports that, following the Asian financial crisis, some *Chaebols* were in financial distress leading to partial liquidation or were sold to foreign investors.

**Table 3** Ownership structure and concentration

| Variable | Obs | Mean | S.D | Q25 | Median | Q75 |
|---|---|---|---|---|---|---|
| *Ownership structure* | | | | | | |
| 1. Individual/family ownership (%) | 1230 | **23.17** | 23.45 | 8.00 | 16.00 | 29.00 |
| Families' and individuals' ownership (%) | 1230 | 15.09 | 24.29 | 0.00 | 0.00 | 20.32 |
| Directors' ownership (%) | 1230 | 8.08 | 17.08 | 0.00 | 0.00 | 6.00 |
| 2. Institutional/state/corporate ownership (%) | 1230 | **76.69** | 25.45 | 70.70 | 87.45 | 92.73 |
| Bank and financial ownership (%) | 1230 | 8.04 | 11.29 | 0.01 | 4.41 | 13.20 |
| Pension fund ownership (%) | 1230 | 1.62 | 4.80 | 0.00 | 0.00 | 1.27 |
| Mutual fund ownership (%) | 1230 | 0.81 | 4.25 | 0.00 | 0.00 | 2.19 |
| State ownership (%) | 1230 | 1.01 | 4.03 | 0.00 | 0.00 | 0.00 |
| Other listed, private and public firm ownership | 1230 | 65.21 | 28.46 | 53.37 | 74.19 | 84.48 |
| Institutional/state/corporate shareholders (number) | 1230 | 7.77 | 4.35 | 4.00 | 8.00 | 10.00 |
| Foreign ownership (%) | 1230 | 16.26 | 27.10 | 0.00 | 01.79 | 22.06 |
| *Ownership concentration* | | | | | | |
| Block ownership concentration (%) | 1230 | **78.80** | 11.57 | 71.26 | 80.03 | 88.11 |
| Block ownership concentr. to individuals/families (%) | 1230 | 12.18 | 21.21 | 0.00 | 0.00 | 13.63 |
| Block ownership concentr. to institut./state/corporations (%) | 1230 | 66.62 | 24.18 | 58.04 | 72.50 | 83.30 |
| Large block ownership concentration (%) | 1230 | **69.08** | 16.90 | 59.13 | 71.10 | 81.54 |
| Individual/family large blocks (%) | 1230 | 8.83 | 19.17 | 0.00 | 0.00 | 0.00 |
| Institutional/state/corporate large blocks (%) | 1230 | 60.25 | 25.58 | 50.60 | 65.65 | 79.54 |
| State block ownership (%) | 1230 | 2.29 | 9.91 | 0.00 | 0.00 | 0.00 |
| Majority control (% of cases) | 1230 | 64.23 | 47.95 | 0.00 | 1.00 | 1.00 |
| Blocking minority (% of cases) | 1230 | 90.65 | 29.12 | 1.00 | 1.00 | 1.00 |
| Family or individual largest shareholder (% of cases) | 1230 | 11.95 | 32.45 | 0.00 | 0.00 | 0.00 |

*Source* Hand collected and averaged by the authors

This table presents summary statistics for ownership structure and concentration of Sri Lankan listed firms. The sample includes the 205 firms listed on the Colombo Stock Exchange. We show averages of firm-year observations with a panel data time frame of 6 years starting in the financial year 2011/2012. We accessed ownership data through the "shareholder information" and "annual report of directors" sections of firms' annual reports. *Individual/family ownership* is the percentage of shares held by families and individuals, and board members. *Institutional/state/corporate ownership* is the share ownership of bank and financial firms, pension funds, mutual funds, government treasury, other listed and private firms, and state-owned enterprises. *Institutional/state/corporate shareholders (number)* is the number of these types of individual shareholders within the top-20 shareholders. *Foreign ownership* is the non-resident shareholdings held by individual, institutional, and corporate shareholders. *Block ownership concentration* is the total percentage of share blocks of 3% or more which is concentrated in the hands of the various types of shareholders (above). Large b*lock ownership* is the total percentage of share blocks of 10% or more held by blockholders of the types mentioned above. *State block ownership* represents the total percentage of share blocks (10% or more) held by the treasury, state-owned enterprises, and other public sector organizations. *Majority control* is a dummy variable that indicates whether the firm is controlled (more than 50%) by an individual or a family or a corporation. *Blocking minority* is a dummy variable that measures whether the largest shareholder owns 25% or more of the equity. *Family or individual largest shareholder* is a dummy variable that shows whether the largest shareholder is a family or an individual shareholders (both domestic and foreign). The combined equity stakes held by families and individuals amounts to 15.09%, and (executive and non-executive) board members own 8%. The average ownership concentration held by families and individuals is declining: it has decreased to 10% in 2019/2020. 76.69% of the equity is held by non-individual/family shareholders: banks and financial firms own 8.04%, pension funds 1.62%, mutual funds 0.81%, and the state 1.01%. The remainder (65.21%) is held by corporations (listed and private firms as well as state-owned enterprises (SOEs)). During first 5 years (starting from 2011/2012), such equity held by corporations amounted to 65%, but it is 68% on average for subsequent 4 years. This average equity stake held by large companies (S&P SL 20 companies)[25] reaches 8% in 2017/2018. The combined total share stake held by foreign individual, institutional. and corporate shareholders amounts to 16.26%.

The cumulative ownership of large shareholders (defined as the owners of share blocks of 3% or more) amounts to 78.80%, which can be partitioned into individual/family ownership (12.18%) and institutional/state/corporate ownership (66.62%). The latter has recently increased to 69% in 2019/2020. The average cumulative ownership of large blockholders (defined as holding share blocks of 10% or more) amounts to 69.08%; 8.83% is owned by individuals/families and 60.25% by institutional investors, the state and corporations. The average number of such institutional/state/corporate blockholders by firm is on average 0.58, and reaches 1.5 in 2019/2020. In the sample firms, block shares (10% or more) held by the government and its affiliated firms amount to 2.29% on average; only about 9% of firms have such block shares. Holderness' (2009) cross-country comparison shows that the average blockholders in non-US firms is 36%. Concentrated ownership (defined as 5% or more) is the highest in Thailand (73%) but large shareblocks appear in all Asian sample firms such as Hong Kong, Indonesia, Malaysia, Philippines, Singapore, and Taiwan. We show in Table 3 that in 64.23% of Sri Lankan firms, a single shareholder holds a majority of the shares and in 90.65% a shareholders holds at least a blocking minority of 25%. In 11.95% of firms, a family or individual is the largest shareholder. Regardless of the shareholder type, the largest shareholder on average owns 53% of a firm's equity for the 5 years starting from 2011/2012, but this stake increases to 55% over the next 4 years.

Minority shareholder expropriation is a typical agency problem arising in markets where dominating shareholders are present. Claessens and Fan (2002) and Haque (2015) document that the risk of expropriation of minority's rights often arises in Asian companies. Claessens et al. (1999) report a negative relation between control rights concentration and share price valuation in East Asia, which could be the consequence of the expropriation of minorities by controlling owners. Cash flow manipulation by major shareholders has been shown to be a way by which minority shareholders' rights are violated in Indian firms, and Nagar and Raithatha (2016) argue that this problem is unlikely to be curbed by board diligence and a sound audit. Expropriation of minorities' rights may also apply Sri Lankan firms because

[25] The most liquid, financially viable, and largest 20 companies are included in the S&P SL20 price index.

of the weak protection of minority shareholders' rights and judicial enforcement of regulations (Appendices A and B).

In Sri Lanka, controlling owners have control rights in excess of cash flow rights via pyramidal or cross-shareholding structures (Mapitiya et al., 2016). In particular, such pyramidal ownership structures are often observed in family firms. While a family or an individual is reported as the largest shareholder at 11.95% of observations (Table 3), the real control power of families can be much higher because of family as ultimate beneficial owners can use intermediate investment vehicles to control firms. If the control throughout the chain of investment vehicles is not interrupted, the ultimate beneficial owner can control significant share blocks with relatively little investment because at every intermediate level, minority shareholders co-finance. In addition to the concentrated control held by families in Sri Lanka, their corporate impact is not only derived from voting rights, but also extends by means of family members' representation on the board of directors and top management positions (Kuruppuge et al., 2018). Claessens and Fan (2002) conclude that family ownership concentration in Asia deteriorates sound corporate governance, which is confirmed by Dharmadasa et al. (2014) who report a negative relation between family ownership and corporate performance in Sri Lanka.

By means of control pyramids, business conglomerate can also be established; one parent firm can thus control a host of other firms. A prominent example in Sri Lanka is *Vallibel One,* the spider in the web of a complex corporate network (see Fig. 1). In such a business network, profit can be maximized in specific firms by means of transfer pricing at the expense of other firms and their minority shareholders. Referring to the East Asian crisis in 1997, Lemmon and Lins (2003) find that the separation between cash flow rights and control rights creates incentives for insiders to expropriate the value of other shareholders. Mitton (2002) confirms that when voting right concentration is larger than cash flow rights, firms generate significantly lower returns as the dominating shareholders can extract private benefits of control.

The empirical studies on the relationship between ownership concentration and corporate performance for Sri Lankan companies are inconclusive. Manawaduge and De Zoysa (2013) identify a positive relation with accounting measures, whereas others (Pathirawasam & Wickremasinghe, 2012) do not find any relation or a negative one (Chandrasena & Kulathunga, 2015). One reason why strong ownership concentration correlates with poor performance may be because it also goes hand in hand with lower compliance with corporate governance practices and may induce agency problems (Kuruppuge et al., 2018). For Indian firms, Arora and Sharma (2016) establish that concentrated ownership of institutional shareholders positively affects firm value.

## 4 The role of banks in Sri Lanka

Sri Lankan banks can provide additional important source of corporate monitoring as Sri Lankan firms strongly depend on bank financing as the primary source of funds. Over the past decade, domestic credits by banks to the private sector amounted to approximately 50% of GDP. The Sri Lankan corporate bond market is

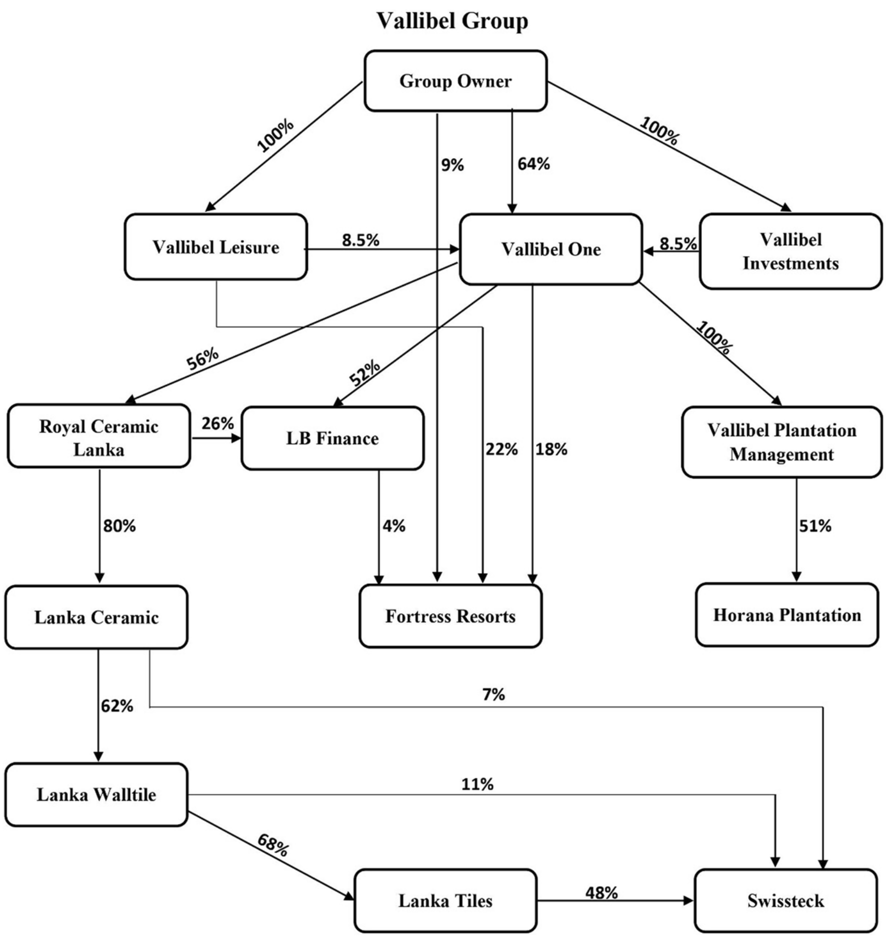


**Fig. 1** An illustration of control pyramids. This figure illustrates how control pyramids work in the Sri Lankan corporate sector. *Vallibel* is a business conglomerate led by an individual who exerts controlling power over many businesses. By means of the pyramidal structure, his control rights far exceed his cash flow rights. The percentages in the figure represent ownership rights (voting rights). *Source* Companies' annual reports (2020)

still underdeveloped; only eight companies issued corporate debentures in 2020. The United Nations data on financial development (Appendix 3) shows that the financial development of Sri Lanka relative to some Asian benchmark countries is among the poorest of the region. Both its financial institutional development as well as its financial market development are lingering.

Shareholder-debtholder agency problems have several sources. First, firms may reject positive NPV projects if the firm's existing debtholders are expected to capture most of the project's benefits (debt overhang (see Myers & Majluf, 1984). This problem could arise in Sri Lanka as companies have high leverage, a consequence of the state banks' policy to offer cheap credit.[26] Second, firms may prefer less profitable short-term projects (financed through favorable credit terms) over more profitable long-term projects as sudden policy changes of the government (e.g., import restrictions), disasters, and terrorist attacks could adversely affect long-term projects (leading to myopic investments). Third, the equity holders may want to keep the firm alive when there is a small probability that the firm will survive as they are residual claimants (reluctance to liquidate). Thus, Sri Lankan firms may be affected by debtholder-equity holder conflicts when shareholders transfer their business risk largely to debtholders as described above. Particularly under the debt overhang problem, firms with free cash flows borrow funds to finance investment projects instead of utilizing internal funds. For a sample of 205 listed firms in Sri Lanka, we find that firms with greater free cash flows are highly leveraged (at 75%).[27] High leverage may also create financial trouble and may enable banks to extract corporate resources or exert excessive monitoring of a firm's operations. Comparing the effects of owner-governance and lender-governance mechanisms, Ekanayake et al. (2019) conclude that lender-governance mechanisms deteriorate corporate performance.

Another consequence of the bank-based lending economy, such as is the case in Sri Lanka, is that banks have substantial monitoring power over firms. The typical corporate banker is a commercial bank who usually also plays the role of investment bank. For instance, banks orchestrate public equity issuances. Banks closely scrutinize firms' transactions with external parties as bank account balances and assets are kept as the collateral for the loans granted. Bank and financial firms also hold significant share stakes, averaging to 8.04%, in listed firms (Table 3) and are also represented on the board of directors.

In relation to debtholder-shareholder agency problems, lenders in Sri Lanka may be less likely to be expropriated by controlling shareholders as the CBSL imposes strict rules and regulations on banks and financial institutions (Perera, 2010). The CBSL has a separate bank supervision division that monitors all the banks' operations, including its equity investments, through the Banking Act No. 30 of 1988 (amended in 2006) and by monitoring and (dis)approving appointments and resignations of banks' directors the banks' representatives on corporate boards. When the Sri Lankan government launches some private sector development loan schemes through state-owned banks such that corporate borrowers with strong political connections could enjoy liberal credit terms, both the state-owned banks as well as the shareholders of the corporate borrows could suffer from over-indebtedness. (Appendix 2 shows that the country's creditor protection status is rather poor.)

[26] For instance, in 2019, the newly elected government considerably decreased the average weighted prime lending rates of commercial banks to 5–6%. Thus, the private sector immediately resorted to large bank loans expecting that the government would withdraw this lower interest rate policy soon. Following the rush towards cheap credits, the quality of investment projects (NPV) could not be properly assessed by banks.

[27] We calculate free cash flow as [earnings before interest and taxes (1-tax rate) + depreciation and amortization − investments (including M&A expenditure) ± changes in net working capital]/total assets at the beginning of the fiscal year. Leverage is measured as total liabilities scaled by total assets.

## 5 Board structure and managerial behavior

### 5.1 Corporate boards

#### 5.1.1 Board structure

Following the Anglo-American model, Sri Lankan firms adopted a one-tier (unified) board structure that comprises both executive and non-executive directors.[28] The unified board structure largely focuses on shareholder primacy, board independence, and board committees (Block & Gerstner, 2016). According to the corporate governance code of 2017, Sri Lankan firms are recommended to appoint several non-executive directors (NEDs) with sufficient relevant experience and skills. Particularly, firms should assure that sufficient financial acumen is present on their boards. The board should comprise three NEDs or the number of NEDs should equal at least one-third of the total number of directors, whichever is higher. If the CEO and the board chair are the same person or if the chairman is not an independent NED, the majority of board members should be NEDs. Firms with a small market capitalization (e.g., firms listed in the *Diri Savi board*[29]) need to have at least two NEDs. The board of directors establishes board committees comprising remuneration, audit, and related party transaction review committees, that should comprise exclusively NEDs and count a minimum of three NEDs. For the nomination committee, the majority of members should be NEDs. NEDs' board membership should prevail for specified terms but NEDs can be re-appointed following an election.

#### 5.1.2 Board size

Sri Lankan board sizes show a large variation. Table 4 shows that approximately eight members are present on the average board and board size ranges from 3 to 15 members. Over the most recent years, board size has remained stable with an average of 7.83 members. Firms with a low number of directors tend to be in financial distress. For instance, only three directors are present in seven firms out of which four firms are financially distressed. Most boards (76%) consist of five to nine members. In such firms, corporate performance (measured by earnings before interest and taxes to total assets at the beginning of the period) is higher (10%) compared to firms with a number of directors outside this range (4%). Having a large board does not necessarily guarantee better monitoring or decision making as, in line with Yermack (1996), a large board size in Sri Lanka is correlated with poor corporate performance (Azeez, 2015; Dharmadasa et al., 2014). This seems also the case in India (Kumar & Singh, 2013).

[28] Gillette et al. (2008) discuss different forms of director board structures comprising single-tiered boards, two-tiered boards, insider-controlled boards, and outsider-controlled boards.

[29] Companies which have a minimum of Rs. 100 million stated capital at the point of listing, are listed in the *Diri Savi board* of the CSE. Companies with a minimum of Rs. 500 million stated capital are listed in the Main Board.

### 5.1.3 Monitoring and board independence

NEDs make up 70.79% of Sri Lankan boards over our time window (Table 4); passing the corporate governance code's minimum requirement of one-third. The percentage of NEDs is gradually rising during a 5 year period from 2011/2012, it amounted to 70%, but then increased to 72% in the subsequent 4 years, further increasing to 75% in 2019/2020. Although the NED rule is mandatory, some firms still fail to satisfy the minimum requirement of NEDs. In family firms, family members usually dominate both executive and non-executive director seats. Also, NEDs may have previously worked as part of the executive team. Azeez (2015) shows that the proportion of NEDs is negatively related to corporate performance in Sri Lanka, while Heenetigala and Armstrong's (2011) analysis fails to support this finding.[30]

The separation of duties between the CEO and chairman is also key to assuring the board's independence. Resource dependency theory treats NEDs as a critical link with the outside environment. Still, not all NEDs, although they are outsiders, are independent. Independent directors are NEDs who do not have any personal or economic relation with the firm and its management (Hsu & Wu, 2014).

The corporate governance code of Sri Lanka incorporates the following board independence criteria: whenever the board's acts of incorporation recommends only three NEDs, all three NEDs should be independent. If the board chair is also the CEO, or if the chairman is not independent, one of the independent NEDs should be appointed as the senior independent director. The degree of independence should be verified annually. Table 4 exhibits that the proportion of independent NEDs is merely 38.88%, and that CEO duality (separation) is present in 75.77% of firms over our time window. Both percentages are increasing: to 40% and 78% respectively, in 2019/2020. Non-family members hold board seats in 82.4% of firms. In family firms, board independence is less likely to be prevalent following family directorships, and a family member (often the founding chairman) tends to hold both the positions of CEO and chairman. Dharmadasa et al. (2014) observe a positive relation between board independence and corporate performance in Sri Lanka. It should be noted that during the early periods of corporate governance reforms, the independence of NEDs was problematic, in that many were gray directors (directors with personal or economic connections to the management and the firm). Even now, such gray directorships are characterized by family ties with existing directors, past employment relationships with the firm and related-party transactions. In India, corporate governance reforms have also emphasized the role of independent directors in boards (Bose, 2009). They require an impactful presence of independent directors on boards and audit committees alongside a code of conduct for board members, a wider role for the audit committee, mandatory risk assessments, and a certification by CEO and CFO on the effectiveness of internal accounting controls.

[30] Gunetilleke (2009) reviews the role of NEDs in the UK (the alternative investment market) and Sri Lanka. He found large similarities between Sri Lanka's firms and the UK's AIM companies which rely on non-statutory codes of conduct.

**Table 4** Board structure, characteristics, and executive ownership

| Variable | Observations | Mean | S.D | Q25 | Median | Q75 |
|---|---|---|---|---|---|---|
| *Board structure and characteristics* | | | | | | |
| Board size (number) | 1230 | 7.83 | 2.10 | 6.00 | 8.00 | 9.00 |
| Non-executive directorships (%) | 1230 | 70.79 | 19.57 | 57.14 | 71.43 | 85.71 |
| Board independence (%) | 1230 | 38.88 | 13.31 | 30.00 | 37.50 | 45.45 |
| CEO's unitary leadership (dummy; in %) | 1230 | 24.23 | 42.86 | 0.00 | 0.00 | 0.00 |
| Family directorship (%) | 1230 | 17.60 | 20.38 | 0.00 | 0.00 | 33.33 |
| *Board and Managerial Ownership* | | | | | | |
| Board ownership (%) | 1230 | 8.08 | 17.08 | 0.00 | 0.00 | 6.00 |
| Board ownership (5%-25%) (dummy; in %) | 1230 | 15.77 | 36.46 | 0.00 | 0.00 | 0.00 |
| Board ownership (10% within top 5) (dummy; in %) | 1230 | 17.48 | 38.00 | 0.00 | 0.00 | 0.00 |
| Board block ownership (%) | 1230 | 5.82 | 15.68 | 0.00 | 0.00 | 0.00 |
| Inside director ownership (%) | 1230 | 5.99 | 15.30 | 0.00 | 0.00 | 1.47 |
| Executive director ownership (%) | 1230 | 1.33 | 5.16 | 0.00 | 0.00 | 0.00 |
| CEO ownership (%) | 1230 | 3.35 | 10.46 | 0.00 | 0.00 | 0.03 |
| Non-executive director ownership (%) | 1230 | 2.16 | 6.15 | 0.00 | 0.00 | 0.76 |

*Source* Hand collected and averaged by the authors

This table presents summary statistics for board structure and ownership. The sample includes 205 listed firms in the Colombo Stock Exchange. The data are based on a panel comprising 6 years starting from 2011/2012. Board structure and ownership data are from the *annual report of directors* section of annual reports. *Board size* is the number of directors. *Non-executive directorships* is a ratio indicating the percentage of non-executive directors on the board. *Board independence* is the proportion of independent non-executive directors (i.e. defined as directors with no former relational ties with the company or a parent company). *CEO's unitary leadership* is a dummy variable that considers whether the same person holds the CEO and chair positions. *Family directorship* represents the percentage of directors belonging to the same family. *Board ownership* is the share ownership held by board members. *Board ownership (5%-25%)* and *Board ownership (10% within top 5)* are respectively a dummy variable indicating whether directors' ownership ranges from 5 to 25% and a dummy variable that considers whether directors' ownership is 10% or more among top-five shareholders. *Board block ownership* is the total proportion of share blocks (10% or more) held by directors. *Inside director ownership* is the share ownership of all directors (executive and non-executive). *Executive director ownership* is the proportion of shares held by executive directors excluding CEO. *CEO ownership* is the equity ownership of the CEO. *Non-executive director ownership* is the percentage of shares held by outside (non-executive) directors

### 5.1.4 Political connections

Sri Lankan board members often have strong political ties. It is common that large shareholders or key officers are (former) top government officials, or have direct or indirect affiliations with members of parliament (MPs), or belong to the network of political parties. For instance, Faccio and Parsley (2009) find that the sudden death of a politician creates a − 0.43% abnormal return for an average Sri Lankan firm within a 10-day window. Our descriptive analysis shows that the CEOs have political connections in 7.14% of firms (Table 5). However, this is likely to be an underestimation as political connections are often not visible to researchers given the opacity of the process of board appointments. Berkman and Galpoththage (2016) treat

**Table 5** CEO characteristics

| Variable | Observations | Mean | S.D | Q25 | Median | Q75 |
|---|---|---|---|---|---|---|
| **Sources of CEO power** | | | | | | |
| CEO's unitary leadership (dummy;%) | 1822 | 25.47 | 43.58 | 0.00 | 0.00 | 100.00 |
| CEO ownership (%) | 1822 | 5.10 | 13.92 | 0.00 | 0.00 | 0.47 |
| CEO tenure (number) | 1822 | 7.15 | 6.61 | 3.00 | 5.00 | 9.00 |
| CEO cross-directorships (number) | 1822 | 4.23 | 5.91 | 1.00 | 3.00 | 6.00 |
| Executive directors (%) | 1822 | 28.86 | 19.55 | 14.29 | 28.57 | 42.86 |
| Directors with CEO's ethnicity (%) | 1822 | 55.64 | 24.80 | 40.00 | 55.56 | 75.00 |
| Sinhalese-Buddhist CEO (dummy; %) | 1822 | 47.75 | 49.96 | 0.00 | 0.00 | 100.00 |
| CEO gender (male = 1; in %) | 1822 | 93.36 | 24.91 | 100.00 | 100.00 | 100.00 |
| CEO political connections (dummy; in %) | 1822 | 7.14 | 25.75 | 0.00 | 0.00 | 0.00 |
| CEO critical knowledge (dummy; in %) | 1822 | 57.35 | 54.49 | 0.00 | 100.00 | 100.00 |

*Source* Hand collected and averaged by the authors

This table presents summary statistics of a CEO's power in Sri Lankan firms. The sample includes the 205 listed firms of the Colombo Stock Exchange. The panel window has 9 years and starts in 2011. The CEO data are from the *Directors' profiles* and *Report of directors* sections of the annual reports. *CEO's unitary leadership* is a dummy variable that indicates whether the same person holds the positions of CEO and chairman. *CEO ownership* is the equity ownership held by the CEO and his family. *CEO tenure* is the number of years a person has held the position of CEO. *CEO cross-directorships* is number of board seats in other firms. *Executive directors* is the proportion of executive directors on the board. *Directors with CEO's ethnicity* is the proportion of directors who have the same ethnicity as the CEO. *Sinhalese-Buddhist CEO* is a dummy variable indicating whether the CEO is a Sinhalese-Buddhist. *CEO gender* is a dummy variable that is 1 when the CEO is male and zero otherwise. *CEO political connections* is a dummy variable that treats CEO as politically connected if he is a member of the parliament, a chief minister of a province, a provincial minister, closely related to a top politician or political party, or is working (or has worked) in a government-affiliated institution. *CEO critical knowledge* is a dummy variable that captures whether CEO has at least a master's degree or a professional qualification

Sri Lankan firms as politically connected if one of the high-ranked firm employees such as the Chairman, CEO, or directors, is connected with MPs, ministers, or ministerial secretaries. They find that on average, 12 firms out of their sample of 99 firms are politically connected. Their study further examines corporate performance in a context of political connections and reveals that politically connected firms generate better performance than firms without political affiliations. It is common that certain economic government decisions are taken to favor firms with close political connections (e.g., the 30-year government bond issue in 2015 is a clear example of political collusion).[31] Likewise firms engaging in government development projects tend to foster strong political ties. An example of a politically connected firm is

[31] In 2015, a bond auction for one billion rupees was approved, and the dealers were preparing their bids for that value. Bids were accepted up to ten billion rupees at a coupon rate of 11.73%, which was the lowest rate compared to the five previous 30-year bond issues. One of the dealing companies was offered five billion rupees worth bonds. Usually, the Central Bank governor is politically appointed. The owner of the dealing company was the son-in-law of the governor. In addition, a sister of the former governor was a board member of the dealer's holding company.

*Ceylon Tobacco Company,* for which Perera et al. (2018) document that five out of twelve directors also held leading positions in the government directly appointed by the president or a minister.

Political connections of directors can also create costs to corporations. After the elections, politicians often ask politically connected managers and directors to recruit supporters/party members and to engage in activities beneficial to local communities. While such actions could be regarded as part of corporate social responsibility (Liang & Renneboog, 2017), it is doubtful whether corporate recruiting of members of political parties or investment in local communities to please regional politicians would lead to any value creation (even in the long-run).[32] Besides, directors with political connections may undermine firm value in several ways: (i) political bodies may direct politically connected directors to encourage the management to accept less viable government development projects, (ii) directors with political ties may interfere with dividend distribution decisions that benefit politically connected shareholders, and (iii) politically connected directors can be appointed to multiple positions in competitive state-owned firms. Political connections could induce corruption; for instance, politicians may earn commissions on government tender offers. The corruption control index (Appendix 1) shows that Sri Lanka is one of the most corrupt countries among developing countries. As a consequence, the IMF has demanded that Sri Lanka upgrade its anti-corruption legislation in order to strengthen anti-money laundering policies and to combat the financing of terrorism (IMF, 2022).

## 5.2 Managers

### 5.2.1 CEO duality

In Sri Lanka, the corporate governance code requires a clear division of roles of the CEO[33] and chairman. We observe in Table 5 that in 25.47% of the sample firms, the CEO also combines the role of chairman, but CEO duality is gradually declining: it was 27% from 2011 to 2016 and 22% thereafter. This is significantly lower than for, for instance, US firms, but still significantly higher than some European countries.[34]

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[32] Bertrand et al. (2018) discuss the cost of political connections of French firms; politically connected CEOs recruit people who supported politicians during the election periods.

[33] The leadership structures among Sri Lankan firms can be quite different. Although corporate governance codes require a clear division between CEO's and chairman's roles, in some firms there is no CEO position but only a managing director. In *Ceylinco Insurance, Hatton National Bank, and Bairaha Farms,* a CEO also holds the title of managing director. In some other firms, both a CEO and managing director are present whereby the latter is a board member and the former not (e.g., *Arpico Finance Company).* In some cases, the chairman is a NED, and the board does not include any executive directors nor the CEO (e.g., *Amana Takaful, Colombo Trust Finance).* There are many violations to the board balance criteria of the corporate governance code.

[34] In the US, the CEO holds the position of chairman in more than 80% of large firms in the 1990s (Brickley et al., 1997). This percentage fell to 54% in 2010 (Yang & Zhao, 2014). In Europe, Broye et al. (2017) stress that the vast majority of companies in the UK, Germany, Austria, Denmark, and Finland separate CEO and chair positions.

The research on the effect of CEO duality on corporate performance yields mixed results. Wijethilake et al. (2015) show a positive relation for Sri Lanka, but Azeez (2015) finds the opposite. For manufacturing firms, Dissanayke et al. (2017) conclude that unitary leadership is correlated with financial difficulties.

There are two main theories on corporate leadership: agency theory and stewardship theory. As postulated by the agency theory (Fama & Jensen, 1983; Jensen & Meckling, 1976), shareholders expect better board monitoring when the duties of CEO and chair are separated. Corporate monitoring is supposed to be more assured in the presence of an independent board chair. Stewardship theory (a, Schoorman and Donaldson, 1997) argues that managers act as stewards of shareholders' investment and do not pursue their personal goals. In this framework, the CEO-chair combination can bring about certain advantages, such as the presence of a unified command, no role ambiguities, and no conflicts between the CEO and chairman.

### 5.2.2 CEO power

CEO's power is not only enhanced by the lack of CEO duality (i.e., structural power), but also by other factors such as their equity stake in the firm, experience, or influence derived from cross-directorships. A CEO's direct shareholding is a common power proxy as a substantial share stake enables the CEO to exercise voting rights and hence exert some control over the board. A long tenure can enhance a CEOs' power because they may have built firm-specific human capital, have more information about the firm than (non-)executive directors with lower tenure (in whose hiring process the CEO may have been involved) (Han Kim & Lu, 2011). CEO's power enables him to substantially influence corporate decisions affecting performance (Berger et al., 2016). Executive compensation, CEO duality (structural power), and cross-directorships of executive directors (expertise power) enhance corporate performance in India (Saravanan et al., 2017). A frequently used proxy of expertise is the number of non-executive board seats in other corporations (Ting & Huang, 2018; Ting et al., 2017).

Table 5 displays several CEO and board characteristics. The CEO's structural power is captured by CEO's unitary leadership: he holds both the positions of CEO (or managing director) and board chair in approximately a quarter of the firms. A CEO's equity ownership averages 5.10% and the average tenure amounts to 7 years. For the 5 years starting in 2011/2012, an average CEO held office for 6 years, increasing to an average of 8 years over the next 4 years. A CEO usually holds four directorships in other firms, and this number has remained stable over the past decade. The number of executive directors and the number of all directors who belong to the CEO's ethnicity amount to 28.86% and 55.64%, respectively. 47.75% of the CEOs are Sinhalese-Buddhists, the dominant ethnicity in Sri Lanka. In merely 7% of firms, the CEO is female, but since 2016, there is an upward trend averaging

9%. Seven percent of CEOs are politically connected,[35] and 57.35% hold a master's degree or a professional qualification. Such politically connected CEOs are present in on average 9% over the period 2016–2020.

#### 5.2.3 Executive ownership

The convergence of interest hypothesis of executive ownership (Jensen & Meckling, 1976) states that increasing directors' equity stakes make them shareholders which leads to corporate decisions that are value-driven and hence positively affect corporate performance. Morck et al. (1988) and Lilienfeld-Toal and Ruenzi (2014) find a positive effect of executive ownership on corporate performance, although strong managerial ownership concentration could induce entrenchment effects and hence negatively affect performance (McConnell & Servaes, 1990). Equity-based executive compensation can partially mitigate the conflict of interest between managers and shareholders.

The equity ownership among Sri Lankan managers also exhibits variation. Table 4 shows that all (both executive and non-executive) directors' combined ownership amounts to 8.08% (with a standard deviation of 17.08%). A strong equity stake (5% to 25%) is present in 15.77% of the firms. Among the top-5 shareholders, directors owning 10% or more of the equity is reported in 17.48% of the firm. The CEO holds on average 3.35% of the shares. Wijethilake et al. (2015) and Guo and Kga (2012) document that large equity ownership held by (executive and non-executive) directors positively affects corporate performance.

## 6 The market for corporate control

### 6.1 Capital market development, and IPOs

The capital market of Sri Lanka is still underdeveloped. The domestic and international capital flows to the equity market are limited because shareholder protection has not induced sufficient trust, which entails that firms rely largely on bank finance. La Porta et al. (1997b) argue that the level of trust is lower in countries with large ethno-linguistic diversity and hierarchical religion. A lack of trust has repercussions on international investments: the FDI net inflows are significantly lower in Sri Lanka than in the OECD countries (the FDI net inflow as a percentage of GDP amounted to 0.70 in Sri Lanka in 2021 versus 1.90 for the OECD; Appendix 4.1). Over the 2015–2021 period, the stock price indices remained stable as are the number of listed entities (Appendix 4.2), in spite of the IPO market seems modest with about nineteen new issues over the last 8 years (Appendix 5).

[35] A CEO is considered as politically connected when he is a member of the parliament, a chief minister of a province, a provincial minister, closely related to a top politician or political party, or has worked/is working in a government-affiliated institution.

Sri Lankan civil war and other political troubles have affected the development of the IPO market. During the early period of the civil war (1991–2000), an average of nine firms were annually introduced on the stock market, but thereinafter (during the critical period of the war from 2001 to 2009), this average decreased to merely three IPOs per year. Since the end of the civil war, the IPO introduction rate has gone up to an annual of 8. Ediriwickrama and Azeez (2016) document that IPO performance was significantly negatively affected by war-related incidents between 2000 and 2009.

Sri Lankan IPO returns also exhibit the two well-known pricing anomalies: short-run underpricing and long-run underperformance. In relation to the former, IPO underpricing in Sri Lanka was around 34% on average (for 105 IPOs introduced during 1987–2008). The magnitude of the underpricing is negatively correlated with the size of the offering (Samarakoon, 2010). Moreover, the underpricing was much larger for privatized (previously state-owned) firms (at 68.5%) than for conventional introductions (at 19.4%). Peter (2007, 2015) also documents that privatized IPOs generate higher initial returns than non-privatized ones. IPO underpricing persisted over the past two decades but varied across industries.[36] The size of underpricing depends on the quality of corporate governance: Samarakoon and Perera (2018) show that IPO underpricing is positively related to the presence of blockholder ownership, dual leadership, and the percentage of NEDs on the board, and is negatively related to board size. Our descriptive analysis based on more recent data confirms positive initial returns after the public offerings (Appendix 5). The IPOs launched in finance, insurance, and real estate industries report for greater underpricing. For instance, *Amana Bank*—the only Islamic banking company whose major shareholders and most directors are Moors—launched its IPO in 2014, and resulted in higher negative returns.

The second anomaly is long-run IPO underperformance. Ediriwickrama and Azeez (2017) observe long-run price under-performance (even after correcting for an illiquidity premium) since 2003, but the underperformance is less prevalent in the post-war period. During 1996–2000, Peter (2007) confirms that new issues generate poor returns during the first year of listing. After the war, Peter (2015) finds that IPOs bring a positive excess return after 6 months of launching the issue and a significant holding period return after their second year. We find many IPOs launched after 2014 incur long-term underperformance (Appendix 5).[37]

[36] Samarakoon and Perera (2018) find that 44 IPOs were underpriced by 30% (in the period 2003 to 2015). Peter (2007) investigates the period of 1996–2000 and reports that: (i) IPO subscribers earn an initial excess return of 57.2%, and (ii) 77% of the 30 IPOs generate positive returns. The highest average initial returns are found in the manufacturing sector. With regard to privatized IPOs, in the hotel and travel sectors the highest IPO returns are found, followed by the footwear and textile sector (Samarakoon, 2010).

[37] IPO pricing anomalies persist globally (Ritter, 2003). Chinese IPOs have the highest initial return (256.9%), followed by those of Malaysia (104.1%) and Brazil (78.5%). Indian IPOs account for 35.3%. The initial IPO returns are also positive in Denmark (5.4%), Canada (6.3%), Austria (6.3%), the USA (18.4%) and the UK (17.4%). Kunz and Aggrawal (1994) report underpricing for Mexico (2.8%) and France (4%).

### 6.2 Mergers and acquisitions

The market for corporate control comprises mergers, tender offers, and proxy contests wherein an alternative management competes for the right to govern corporate resources (Jensen & Ruback, 1983). The literature presents inconsistent results on M&A long-term performance. Healy et al. (1992) measure the post-acquisition performance of the 50 largest mergers in the US and conclude that the increased asset productivity in merged firms leads to higher operating cash flow returns, which are already reflected in the positive abnormal stock returns at merger announcements. Conversely, Agrawal et al. (1992) demonstrate that bidding stockholders face negative post-merger returns over a 5-year post-merger period. The European M&A market is more resilient against to the financial shocks compared to the US M&A market (Martynova et al., 2007). Martynova and Renneboog (2008) examine the spillover effect of corporate governance standards on cross-border M&As and find that takeover gains are subject to the relative degree of shareholder protection in the target's and bidder's country.

Low M&A activity is a characteristic of the takeover markets of South Asia and other emerging markets. As emphasized by Rossi and Volpin (2004), the volume of M&A transactions in these countries is determined by the quality of accounting standards and shareholder protection. Still, Ahmed et al. (2018b) who studied M&As in three frontier markets in Asia, Pakistan, Vietnam, and Sri Lanka, reported that Sri Lanka has the highest M&A activity among these markets. Liang et al. (2018) distinguish determinants of cross-border M&A in emerging Asia, including Sri Lanka. Outward M&As are affected by the size of the stock market, local firms seeking to expand towards foreign markets, the availability of natural resources, and lower labor costs; M&A inflows also depend on the availability of bank credit, and stock market liquidity. Goddard et al. (2012) explore bank M&As of Asian and Latin American emerging economies and document that the bidders' shareholders are—unlike those of developed countries—less likely to lose value upon M&A announcements.[38] In emerging markets, shareholders of bank acquirers benefit from geographical diversification.

Since the end of the civil war, few M&A transactions have occurred in Sri Lanka. Dissanayaka and Jayaratne (2017) report that M&A deals in Sri Lanka are restricted because the following factors are missing: technology and financial resources, top management's commitment to control employee resistance, and hands-on managerial experience to handle M&A transactions. M&A activity was particularly concentrated on horizontal mergers and firms from the financial sector merged under the financial sector consolidation plan of the Central Bank. We observe that private firms acquire listed companies, which implies that wealthy families or individuals expand their business groups (Appendix 6).

[38] In Goddard et al. (2012), the Asian sample includes Hong Kong, Indonesia, Malaysia, Singapore, Korea, Thailand, and the Philippines. The Latin American counterparts are Argentina, Brazil, Chile, Columbia, and Peru.

### 6.3 Cross-listings

Local companies seek cross-border listings because the cost of capital may decrease and the market value may increase because new investors can be reached (Merton, 1987). In Sri Lanka, as the local equity investor base is lacking and international capital flow is constrained by poor country ratings, local companies can broaden their investor base through cross-listing in foreign countries and minimize the impact of market manipulations by large domestic investors. Secondly, being listed on a foreign stock exchange requires Sri Lankan firms to comply with the listing requirements of the foreign stock exchange, which enhances trust in the company (Ammer et al., 2004). As such, Sri Lankan firms can signal their quality and enhance their reputation to international investors. Some papers emphasize the relationship between top management turnover and being cross-listed. Lel and Miller (2008) examine this relation for a sample of firms from 47 countries (including Sri Lanka) that have at least one cross-listing in the US. In such firms, CEOs are more frequently replaced when performance disappoints. For the sample of Sri Lankan cross-listed firms, the CEO turnover amounts to 8.11% in the year subsequent to the cross-listing. The authors deduce that the removal of poorly performing CEOs is more probable in firms that augment shareholders' protection by cross-listing in the US. Third, referring to the bonding hypothesis, Coffee (2002) finds that cross-listed firms in the US are more prone to protect minority shareholders' rights, seek more transparency, and comply with the rules of the SEC. Fourth, a cross-listing enhances a stock's price informativeness. Fernandes and Ferreira (2008) compare firm-specific stock return variation across 40 countries and measure stock price informativeness, especially for private information. The Sri Lankan sample in their paper only comprises 25 firms, none of which are cross-listed in the US. The results show that Sri Lanka is the second-lowest (0.596) in relation to price informativeness among the emerging markets. The authors conclude that cross-listings enhance price informativeness in developed market firms, but decrease the informativeness in emerging markets.

Cross-listing of Sri Lankan firms on foreign (especially western) stock exchanges is rare; only one firm (*John Keells Holdings*) is cross-listed in Luxemburg.[39] One possible explanation is the relatively low degree of international trade in Sri Lanka and the modest FDI into the country. Cavoli et al. (2011) study foreign listings of eight Asian countries, comprising Hong Kong, Japan, Korea, Malaysia, Philippines, Singapore, and Taiwan. Cross-border listings of firms from these countries are related to more trade openness, higher output growth, and lower inflation. Both the international trade and FDI openness in Sri Lanka are modest relative to the other sample of countries above. Its trade openness reflects a significant drop during the

[39] Firms involved in cross-listings can have home or/and host status. Home refers to countries whose companies have cross-listed in other countries, while host countries are the cross-listing destinations for companies in other countries. Sarkissian and Schill (2016) make a home and host market analysis on foreign listings and examine 3684 overseas listings in the sample. Sri Lanka reports only one cross-listing in Luxemburg, but is absent as a host. Canada is dominating in the home sample (73 markets) followed by the US. The US and the UK are the leading host nations respectively.

period 2004–2020, particularly during the last years of the civil war (2007–2009). In Singapore, nearly 40% of the stock market is represented by cross-listed firms (the highest in the Asian region) given its higher trade and FDI openness. In Appendix 4.1, we show that FDI openness in South Asia is poor (as FDI net inflows of many South Asian countries are lower than the OECD average) which constrains cross-border listing in this region.[40]

## 7 Corporate social responsibility

### 7.1 CSR engagements and reporting

The goal of firms may go beyond maximizing shareholders' wealth and extend to engaging in corporate social responsibility (CSR) activities. The notion of "shareholder primacy" refers to a shareholder-oriented aspect of corporate governance which highlights that firms should prioritize maximizing shareholders' wealth before catering to the needs of other stakeholders. This argument was raised in the shareholder theory of Friedman (1970) which posits that the primary responsibility of a firm is to its shareholders. Ferrell et al. (2016) document that it is well-monitored firms that invest in CSR projects and not firms riddled with agency problems. In addition, they show that CSR investments are value-enhancing. These empirical findings support the stakeholder theory (Freeman, 1984) which sees firms as social institutions that systematically fulfill the demands of shareholders and all other stakeholders. Liang and Renneboog (2017) show that investing in environmental, social and governance (ESG) projects does not necessarily destroy corporate value; quite on the contrary, they show that stakeholder value maximization is not at odds with shareholder value maximization. This is largely the case in civil law countries (both developed and developing economies).

The recent evolution in Sri Lanka is that CSR disclosure and engagements are increasingly an integral part of corporate reporting. Rajmanthri (2005) investigates how company owners, CEOs, and other managers of Sri Lankan firms perceive the role of CSR. These agents now consider CSR as a part of business practices and intend to focus on performance while taking account of people, environment, and society. Hence, CSR could enhance corporate performance while balancing short-term earnings and long-term growth prospects. Hunter and Wassenhove (2011)

[40] Some efforts were made to promote cross-listings in South Asian countries (SAARC). In 2005, the International Securities Consultancy (ISC) developed a proposal to promote cross-border listings for the South Asian Federation of Exchanges (SAFE) (a cooperative platform of the stock exchanges of South Asian countries) and stresses that SAARC countries have poor intentions to initiate cross-listing and/or trading across SAFE members. The ISC further believes that stringent foreign exchange controls curb the attractiveness of the region for foreign investors'. The stock market participation in these countries is very low as less than 5% of the population hold equities or bonds. ISC highlights the urgency to develop cross-border trading platforms within this region. Romero-Torres et al. (2013) also emphasize the lack of integration among SAARC countries because of the absence of cross-listings and restrictions on capital movements.

discuss corporate responsibility in *Hayleys Plc* from both managerial and stakeholder perspectives. They examine whether CSR is only a cost to the firm or a profitable business strategy. The company is able to enhance trust by providing more transparency on ESG such that the benefit from better stakeholder relations can be monetized.

The Sri Lankan studies show that corporate governance characteristics determine the extent of sustainability reporting (Cooray et al., 2020a, 2020b; Shamil et al., 2014). Sustainability reporting is positively influenced by board size, the presence of a risk management committee, and dual leadership structure. Particularly, younger firms are more likely to offer sustainability reporting. A broader perspective based on an 'integrated view' of the CEO can make his firm to embrace sustainability-based value creation (Herath et al., 2021). Bae et al. (2018) relate sustainability disclosures to some corporate governance elements of firms in India, Pakistan, and Bangladesh. They demonstrate that ESG disclosure is positively and significantly related to foreign shareholdings, institutional ownership, board independence, and board size. The authors also show reveal that environmental sustainability reporting performance (ESRP) is enhanced by foreign, institutional, and director ownership, board independence, and board size, but such ESRP practices are hampered by family control, poor female participation, and limited lack of managerial talent. A focus on CSR is not at odds with the enlightened shareholder approach[41] that suggests that business decision-makers ought not to neglect social and environmental investments in order to maximize long-term financial returns of Sri Lankan firms (Thilakerathne, 2009). Especially, investments in employee-oriented CSR projects translate into higher corporate value. Cooray et al. (2020a, 2020b) examine the effect of the increasing trend in sustainability reporting practices (integrated reporting or IR) on corporate value but do not find a relation. With regard to banks, Abeysinghe and Basnayake (2015) show that CSR disclosure and corporate performance of domestic commercial banks are negatively correlated (state-owned banks hardly report on CSR performance).

One ought to be careful in that CSR activities in Sri Lanka may just be window dressing. Alawattage and Fernando (2017) find that corporate social and environmental accountability reports are still opaque for the average firm and note that tricky textual strategies are applied (imitation of other firms' disclosure). Gunarathne and Senaratne (2017) also claim that many firms have not truly absorbed global integrated reporting (IR) principles related to financial, human, intellectual, and social relationships, and environmental disclosure. Relating to neo-institutional theory, Beddewela and Fairbrass (2016) explain CSR behavior of multinational firms in Sri Lanka that engage in CSR activities in order to gain political advantages and legitimacy. Often following coercive actions by governmental and non-governmental institutional actors, multinational subsidiaries engage in CSR for political reasons rather than for reasons of doing well for society.

[41] Enlightened shareholder value (ESV) is an approach in which firms focus on shareholder wealth with a long-run orientation which is based on sustainable growth and satisfying stakeholders' interest (Millon et al., 2012).

Khan and Beddewela (2008) recognize that cultural differences affect CSR engagement and the reporting on CSR across countries. In Sri Lanka, the degree of CSR depends on whether the firm is local or part of a multinational firm, with the latter being more advanced in terms of CSR awareness. As emphasized by Schuster et al. (2016), the behavior of socially responsible firms in South Asia also reflects religious beliefs (Hinduism, Buddhism, Christianity, and Islam). Some studies (Dissanayake et al., 2016; Fernando et al., 2015) show that cultural and religious awareness and convictions of the corporate decision-makers (families, top management) in Sri Lanka make domestic firms more attentive to social issues (e.g., unemployment and poverty) at the expense of environmental concerns. In contrast, Abeydeera et al. (2016) argue that Buddhist principles and local cultural values have little effect on the degree of ESG orientation of Sri Lankan firms.

### 7.2 Diversity and inclusion

Diversity and inclusion at the employee and board level bring about both benefits and costs. Alesina and La Ferrara (2005) define a diverse society as a non-homogeneous community and propose the term fractionalization as a measure of the number and size of homogeneous subgroups. A cost of diversity in the workplace is that it could result in less teamwork and cohesion (Harjoto et al., 2018) and Pompper (2014) claims that racial differences reduce cooperation among workers. Cox (1991) adds that the costs of workforce diversity also comprise increased employee turnover, personal conflicts, and communication barriers. Conflicts at the board level can arise following disagreements between directors based on diversity (Adams & Ferreira, 2009). Giannetti and Zhao (2019) claim that greater ancestral diversity creates conflicts among directors in US firms and introduces inefficiency in decision-making. In contrast, cultural diversity creates strong benefits such as higher creativity, stronger innovations, customized marketing campaigns (Cox & Blake, 1991), and higher sensitivity to societal diversity (Pompper, 2004).

Diversity at the board level is induced by differences in language, religion, ethnicity, nationality, age, and gender of its directors. In addition, differences in the skills and experiences of directors (e.g. educational qualifications, industry expertise, professional memberships, etc.) contribute to board diversity. Hiring diverse board members with different backgrounds and skills is consistent with the resource dependency theory. Particularly, in the case of Sri Lankan firms that operate in a strongly diverse national context, there is a need to appoint both executive and non-executive directors with different ethnolinguistic backgrounds, which could also enhance board independence (Carter et al., 2003). Although firms are required to maintain a balanced board comprising executive, and (independent) non-executive directors, reserving board seats based on such directors' ethno-linguistic and demographic traits is voluntarily.

As India counts numerous ethno-linguistic and demographic differences which are also reflected in the management, directors, and employees of Indian firms, the study of firm-level diversity in Sri Lanka provides an interesting laboratory, considering past severe tensions that culminated in a civil war and the subsequent reconciliation process. Wellalage and Locke (2013) report that board ethnicity and age diversity of the directors positively affect corporate performance in Sri Lanka, but show that gender, education, and occupational diversity are negatively correlated to performance. They conclude that Sri Lankan boards are still falling short of full diversification because boards often put more emphasis on skill diversity of their members rather than on differences in cultural background. Wellalage et al. (2012) observe that the global financial crisis seems to have encourage the hiring of directors from ethnic minorities. They document that ethnic minority directors are represented on more than 42% Sri Lankan boards by 2010. This positive evolution has continued, rising to 48.5% over the period 2012–2018. Table 6 presents summary statistics for some board diversity dimensions of Sri Lankan firms. The directors speaking minority languages (non-Sinhala) account for 23.64% of firm-year observations, recently increasing to 25% (in 2017/2018). Ethnic minority directors (non-Sinhalese-Buddhists) make up 42.17% of the board out of which Tamils and Moors, and Sinhalese-Catholic account for 22.28% and 20% of the board members, respectively, but a small decrease in ethnic minority representation on the board is visible in recent years.

We further observe a variation across companies in terms of ethno-linguistic representation on the boards. Inclusion of board members with diverse background may be beneficial for firms that target foreign markets. For instance, *Asian Hotels and Properties Plc* (belonging to Cinnamon city hotels that hold a market share of 51% among city hotels in Sri Lanka) has a good track record of a diversified board: 50% of the directors is from an ethnic minority, out of which 27% are either Tamil or Moor (who speak Tamil). Some firms gradually moved towards more ethnic diversity. For instance, *Laugfs Gas Plc*, which was founded by a Sinhalese-Buddhist entrepreneur, was fully dominating by Sinhalese-Buddhist directors until the financial year 2011/2012, but 6 years onwards, ethnic minorities are being appointed to the board: 37% of the directors are Sinhalese-Catholics and 13% are Tamils, and 50% are Moors. An opposite trend is visible at *Hayleys Fabric Plc* whose ultimate owner is a Sinhalese-Catholic businessman. While ethnic minority representation amounted to 50% of the board during the first years of our sample period, with 20% of the board seats are held by Tamils and Moors. At the end of the sample period, minority directorships have decreased to 12.50%, which comprises only Sinhalese-Catholics. Some firms failed to recruit ethnic minorities onto their boards e.g. *ACL Plastics Plc*, *Kandy Hotels Company Plc*, *Samson International Plc*, etc. *Kandy Hotels* locates in an ancient city (*Kandy*), which is largely characterized by the traditional Sinhalese-Buddhist culture. Besides, the trustee of the temple of the sacred tooth relic of “Lord Buddha” is a board member of the hotel.

The analysis of the ethnic composition in board rooms and major shareholders of family firms further provides valid clues on ethnicity-oriented industries of the country. The primary industries such as paddy farming, handicrafts, pottery, metalwork, clay work, etc., which were in the central part of the Sinhalese-Buddhists region during the king era, are still pursued in these region. During the colonization, western colonists first captured coastal areas, and thus, the descendants of the immigrants (the Sinhalese-Catholics) are still residing in those areas and dominate the industries of fishing and animal husbandry. The plantation sector (e.g. tea, rubber, coffee, etc.) is mostly located in the hills and is dominated by Tamils (who originally immigrated from India). As a result, Tamil businessmen historically lead the plantation companies and the estate minister is virtually always Tamil. Moors descent from Arab immigrated traders (who served the silk road) and are mainly involved in trading companies and the textile industry. Consequently, a major part of the wholesale sector is controlled by Moors.

Family firms/business groups often display a certain ethnic orientation, which is reflected in the ethnicity of the majority of directors. As such, directors of any ethnicity can be ethnic minority directors, including Sinhalese-Buddhists (the religious-ethnically dominant group). We capture ethnic minorities by defining a variable "Within-Board Ethnic Minority"; the percentage of directors who do not belong to the major ethnicity of the board amounts to 35.74% (see Table 6). Appointing ethnic-minority directors has somewhat declined in recent years. *Cargills (Ceylon) Plc* is the largest retailer in Sri Lanka founded by David Sime Cargill, a Scottish businessman, in 1844. Its board usually counts a Tamil majority, but other ethnicities (Sinhalese-Buddhists and -Catholics, Moors, and foreigners) make up 49% on average. *Ceylon Foreign Trades Plc* had a majority of Moor directors (62.5%) during first 6 years of the sample period, which declined to 50% in the last year of our sample period. It should be noted that before an increase in the ethnic minorities' representation on the board, firms incur negative accounting performance which suggests that they expect that board diversity could lead to better performance. Some firms with Tamils-dominated boards such as *Renuka Agri Foods Plc, Beruwala Rosorts Plc, Renuka City Hotel Plc, CM Holdings Plc*, have seen a significant drop in ethnic diversity on their boards in 2017/2018, relative to previous years. Other firms, including *Aban Electricals Plc* (Sinhalese-Catholic-oriented), *Serendib Land Plc* (Tamils-oriented), *Bairaha Farms Plc* (Moors-oriented), *Tess Agro Plc* (Sinhalese-Catholic-oriented), have not ensured any reasonable representation of other ethnicities on their boards over the 7-year period starting from 2011/2012, such that in these firms one ethnicity prevails. Board ethnic dominance—two-thirds or more of the directors belong to a single ethnicity—is present in 48.08% of the firms (see Table 6), slightly increasing to 50% by 2017/2018. Foreign and female board members make up on average 10.57% and 7.59% of the directors, respectively, but female and foreign board representation is augmenting in recent years.

Critical mass theory (Konrad et al., 2008; Torchia et al., 2011) highlights women's role on the board and recommends a presence of at least three female directors. In Australia, the presence of women directors is stimulated by female chairpersons, by strong owners (with large share blocks), mature boards (with a high average age), and CEOs with long tenure (Ahmed et al., 2018a). Gender diversity increases corporate innovation (Torchia et al., 2011), improves employer-employee relationships (Li et al., 2018), increases the board's involvement in strategy development (Nielsen & Huse, 2010), and is positively related to stock liquidity (Ahmed & Ali, 2017) and corporate performance (Green & Homroy, 2018; Moreno-Gómez et al., 2018). However, when firms feel pressurized to hire women directors, when they hire candidates without a business background (Hillman et al., 2002) but with family connections (Ruigrok et al., 2007), firm value decreases (Haslam et al., 2010).

**Table 6** Board diversity

| Variable | Observations | Mean | S.D | Q25 | Median | Q75 |
|---|---|---|---|---|---|---|
| *Board diversity indicators* | | | | | | |
| Minority language representation (%) | 1435 | 23.64 | 25.16 | 0.00 | 16.67 | 40.00 |
| Ethnic minority representation (%) | 1435 | 42.17 | 26.82 | 22.22 | 40.00 | 62.50 |
| Tamil and moor minority representation (%) | 1435 | 22.28 | 24.59 | 0.00 | 14.29 | 37.50 |
| Within-board ethnic minority (%) | 1435 | 35.74 | 17.18 | 25.00 | 37.50 | 50.00 |
| Ethnic board dominance (dummy—%) | 1435 | 48.08 | 49.98 | 0.00 | 0.00 | 100.00 |
| Foreign board (%) | 1435 | 10.57 | 17.92 | 0.00 | 0.00 | 14.29 |
| Female board (%) | 1435 | 7.59 | 10.72 | 0.00 | 0.00 | 14.28 |

*Source* Hand collected and averaged by the authors

This table illustrates summary statistics for board diversity indicators of Sri Lankan firms. The sample includes 205 listed firms on the Colombo Stock Exchange. The panel window comprises 7 years starting in 2011. Board diversity data were gathered from the *Directors' profiles* section of the annual reports. *Minority language representation* is the proportion of directors with a non-Sinhala language as native tongue (the data take into account the native tongue of foreign directors). *Ethnic minority representation* is the proportion of ethnic minority directors (directors other than Sinhalese-Buddhists such as Sinhalese-Catholic, Tamils, Moors, and foreigners). *Tamil and Moor minority representation* is the percentage of Tamils and Moor directors. *Within-board ethnic minority* indicates the proportion of directors who do not belong to the dominant family ethnic background of the firm. *Ethnic board dominance* is a dummy variable that indicates whether two-thirds of board members belong to the same family ethnic background. Foreign board is the proportion of foreign directors on the board. *Female board* is the proportion of women directors

Women's employment in Sri Lanka has changed significantly since the government initiative 'Open Economic Policy' from 1977. While there has been an improvement in public (government) employment of women, women still do not hold key positions in the corporate sector. Table 7 summarizes data on labor force participation of women. The unemployment rate of the country amounts to 5.40%, which averages male and female unemployment at 3.90% and 8.40%, respectively. The unemployment of women with advanced education is also higher, at 11.04%, than for their male counterparts. The data on female unemployment are based on the number of women who (want to) work outside the household. The labor force participation rate (that measures active workforce that are currently employed or actively seeking employment) of women amounts to merely 31.80%, lower than half of that of the male population (71%). Most female workers earn a living in the agricultural sector (which employs 27.63%, versus 23.63% of total male employment). Women's labor contribution to the industrial sector (25.87%) is also lower than that of men (28.89%). Self-employment levels of males and females are virtually identical. The percentage of women at senior or middle management positions amounts to 25.60% of total female employment. At the top level, women are scarce: as reported by Cho et al. (2015), there are only 10 top managers out of 198 are women in the 25 leading companies in Sri Lanka. Gomez (2011) refers to a survey on women in senior managerial positions and reveals that there is only one female CEO and no female non-executive directors among the top 40 companies with the highest brand value and that there are only three female CEOs in the subsequent set of 33 companies.

**Table 7** Employment and labor force participation

| Employment and labor force participation | | | |
|---|---|---|---|
| Variables | Male | Female | Total |
| Unemployment (%)—2021 | 3.90 | 8.40 | 5.40 |
| Unemployment with advanced education (%)—2019 | 3.42 | 11.04 | 7.79 |
| Labor force participation rate (%)—2021 | 71.00 | 31.80 | 49.90 |
| Employment in agriculture (%)—2019 | 23.63 | 27.63 | 24.98 |
| Employment in industry (%)—2019 | 28.89 | 25.87 | 27.87 |
| Employment in services (%)—2019 | 47.48 | 46.50 | 47.15 |
| Self-employed (%)—2019 | 42.04 | 41.09 | 41.72 |
| Employers (%)—2019 | 3.70 | 0.93 | 2.77 |
| Employment in senior and middle management (%)—2019 | n.a | 25.60 | n.a |

*Sources* World Bank (2022), Central Bank of Sri Lanka (2021)

This table presents the employment and labor force participation in Sri Lanka. Data are from Central Bank of Sri Lanka and from International Labor Organization available in the World Bank's database. *Unemployment* is presented as a percentage of total labor force. *Unemployment with advanced education* is the percentage of the labor force with advanced education such as a bachelor's degree, a master's degree, or a doctoral degree. *Labor force participation rate* is the percentage of workers in the population aged between 15 and 64 years. Employment of male and female workers is given for the three main sectors (agriculture, industry, and services). *Self-employed* is the percentage of self-employed people out of total employment. *Employers* is the percentage of people out of total employment who provide employments for others. *Employment in senior and middle management* is the percentage of people out of total employment who hold senior or middle management positions

Gender (in)equality in the corporate sector is culturally determined. Cultural characteristics of Sri Lanka limit women from participating in the labor market and entrepreneurship, and from holding key managerial positions. A relatively high percentage of Sri Lankan women (more than 60%) may be coerced to follow social norms that require the fulfillment of well-defined duties within their household and hence not do paid work outside the household. Furthermore, the work-life balance for women who do have an outside job in addition to taking care of the household is harder than for men as women assume more family responsibilities such as taking care of (the education of) the children. Consequently, many women are not treated equally at many societal levels. Private sector firms may give priority to male applicants in the recruitment processes because of women's family commitments, leave requirements (maternity leave, etc.), inability to work long hours, and travel restrictions. Many women are not permitted by fathers or husbands to engage in entrepreneurship. Especially in firms controlled by (Islamic) Moor families, women are not admitted to undertake any business activities.

### 7.3 Socially responsible investments in Sri Lanka

Some investors seek investment vehicles that consider both ethical considerations in relation to Environmental, Social, and Governance (ESG) principles as well as a decent risk-adjusted return. Socially Responsible Investments funds (SRIs) respond to such investors' needs by adjusting the investment universe. Ang and Weber (2018) report that Korea, Malaysia, and Hong Kong are the leading SRI markets in Asia, but that, the Sri Lankan SRI Fund market is rather shallow. This may be due to a lack of awareness among investors and the fact that only a few SRI funds exist in Sri Lanka; e.g., SRI funds managed by Tundra Fonder, a Swedish-based asset management company that focuses on some fastest growing economies (Vietnam, Pakistan, Nigeria, Bangladesh, Kenya, Egypt, and Sri Lanka). Its Tundra Sustainable Frontier Fund invested twenty million dollars (12% of the fund) in Sri Lankan stocks. Although the fund has outperformed its benchmark indices (the MSCI Frontier Markets Index and MSCI Emerging Markets Index), the assets under management (AUM) are still limited. In consultation with Tundra Fonder, the Colombo Stock Exchange encourages listed companies to adopt ESG criteria in their business practices (especially related to environmental sustainability, alternative energy, and clean technology) in order to attract foreign investors. Sri Lanka, as a signatory country of the Paris Agreement since 2016, launched an economic development plan called "Sri Lanka NEXT – Blue Green Era" in order to mitigate climate changes. The Sri Lankan government has also taken important steps to promote impact investing. With an eye on reaching its sustainability goals of 2030, the government has signed two memoranda aligning its policies with the United Nations Development Programme (UNDP) and has agreed to launch the country's first set of social impact funds. These funds will not only facilitate social entrepreneurs to access innovative financing but also comply with the Sustainable Development Goals (SDGs). For instance, the Social Enterprise Fund (SEF) and the Social Impact Capital Fund (SICF) have invested USD 25 million to support small-scale enterprises with a social impact.[42]

Whether socially responsible funds outperform their conventional counterparts is still doubtful in academic fund research. Several papers argue that SRI funds have a poorer reward-risk ratio than the benchmark indices, as active management is expensive (Renneboog et al., 2008). For instance, Chegut et al. (2011) claim that SRIs are not at the efficient frontier of the mean–variance portfolio because the SRI screens constrain investment choices which imply a lower diversification, extensive risk exposure, and additional costs. Similarly, Renneboog et al. (2008) show that investors in SRI funds around the world pay a premium.

### 7.4 Employee rights

The evolution of labor rights in Sri Lanka reached important milestones during the colonial era. Even though the Roman-Dutch law, later substituted by English law, highlighted the contractual master-servant relationship, the *Bracegirdle* Embarrassment (1931) (see Table 1) led to the recognition of labor rights protection. The 1978 Constitution allowed laborers to create and join trade unions, and subsequent labor laws assured employees' social security, welfare, occupational safety and health,

[42] The SEF provides capital of maximally USD 100,000 to micro or small social enterprises. The SICF provides finances to social entrepreneurs whose business model comprises a social impact.

compensation, terms and conditions of employment, and labor relations. The Labor Acts also paid special attention to the rights of plantation laborers. As a member of the International Labor Organization (ILO) since 1948, Sri Lanka requires firms to maintain the ILO standards of labor rights.

Despite efforts to stimulate fairness in employment, many incidents have been reported in relation to the violation of employees' rights and civil liberties. The European Union withdrew from the bilateral trade agreement with Sri Lanka in 2010 because of human rights violations.[43] The International Trade Union Confederation (ITUC) also expressed their worries on several issues, such as delaying certification of union votes by employers,[44] the dismissal of union leaders to prevent union membership expansion,[45] and the gender-pay-gap. Moreover, the Solidarity Center (2016) reports that the peaceful situation after the ethnic conflict in Sri Lanka is yet to bring expected economic and social gains to workers in Jaffna (the capital of Northern province, an area badly affected by war). A majority of workers in the disputed regions are not entitled to legally guaranteed labor rights and lack social protection. Besides, the Solidarity Center reports serious problems of factory workers, particularly female ones who suffered sexual abuse.[46] Another example was the "Private Sector Pension Bill", which was severely contested by thousands of workers in 2011.[47] Appendix 1 reports some examples of the deterioration of civil liberties in terms of voice and accountability in the recent past and also illustrates civil liberty protection in Sri Lanka relative to some benchmark countries (based on the criteria of freedom of speech, participation in selecting the government, and forming associations, and the presence of a free media).

In some Sri Lankan firms Employee Share Option Schemes (ESOS) are offered which makes employees stockholders. Originally, ESOS were first introduced at the privatization of state-owned enterprises (SOEs). The public servants of former SOEs lost their public service status but were granted share ownership in the privatized firms. The CSE has imposed some listing rules pertaining to ESOS, such as adequate disclosure on ESOSs. Appendix 7 summarizes recent ESOS disclosures; e.g. *John Keells Holdings* and *Hemas Holdings* are the frequent issuers of ESOS

43 EU trade agreement: Generalized System of Preferences (GSP) offer developing countries a preferential tariff treatment to export goods to the European market.

44 Employees can claim rights more easily when unions are registered by the Department of Labor; its Labor Relations Board can certify a union as the exclusive bargaining agent on behalf of the employees. Granting this approval is subject to a minimum of 40% of employees' votes in favor of the proposed union. Employers are responsible to organize the vote and counting and certifying the votes. The ITUC blames employers to purposely delay such certification of votes.

45 This issue is common in export processing zones where the government is stimulating employers to accept employees' councils rather than trade unions.

46 The Solidarity Center (2019) further reports that 400 workers in a Sri Lankan factory were on a strike for more than two months, and two workers were on a hunger strike in response to the firing of five union leaders, sexual abuse of women workers, and other forms of gender-based violence.

47 Clashes between protestors and the police resulted in one death and more than 200 injured. Many injured workers lost their jobs because of the need for prolonged medical treatment. This incident caused a major public outcry which was particularly led by many Catholic clergy and human rights activists.

representing the capital goods industry; and the largest issuer is *Amana Bank*, an Islamic banking company.

## 8 Cases of corporate governance failures

The Sri Lankan economy has not only suffered from long-lasting instability and civil war, but also from numerous business failures and scandals that are typically caused by bad corporate governance practices. Van Essen et al. (2013), Wang and Lin (2010) and Bektas and Kaymak (2009) amongst many others regard corporate scandals as lessons in the importance of adopting good governance practices. Sri Lankan firms failed as the result of poorly functioning internal and external monitoring mechanisms and poorly designed managerial incentives. The frequently observed self-interested behavior by management, large shareholders' expropriation, family dominance, and lack of compliance with regulatory requirements have resulted in the bankruptcy of several large financial corporations such as the *Pramuka Savings and Development bank*, *Golden Key*, as well as the non-financial firms like *PC House* and *Touchwood Investments*.

The cost of poor corporate governance practices was the highest for the financial sector in Sri Lanka. The IMF reported in 2016 that several large-scale finance companies were in trouble because of fund mobilization through unauthorized financial products.[48] Exploring two bank scandals in Sri Lanka, Uddin et al. (2017) conclude that the corporate governance practices of both banks deviated from the corporate governance codes. Moreover, the authors also observed that banks did not comply with the Central Bank's regulations, held purely ceremonial board meetings, applied subjective auditing practices, and manipulated decisions taken at the AGM. Particularly harmful was nepotism: the creation of familial directorships, lack of accountability because of family-centered relations, and the involvement families' social networks.

Table 8 showcases several financial and non-financial business failures from the last two decades. It summarizes the major causes of corporate failures including the lack of compliance with regulatory requirements and corporate governance codes, managerial expropriation, inefficient boards, mismanagement, weak internal control systems, and opacity of related party transactions.

The failure of *Pramuka Savings and Development Bank* in 2002 attracted more public attention than any other business failure in the country's corporate history. At the time of the collapse, the bank reported approximately USD 31 million of junk-level debt, resulting in a negative net worth of around USD 3 million. The case is important because *Pramuka Bank* was the first bank that was liquidated in the country and its failure created a major bank run and panic among shareholders and

[48] Of the 46 financial companies, 15 faced severe liquidity issues, and 6 were in financial distress following the investment of depositors' funds in financial products that are unauthorized by the Central Bank. In addition, firms' financial positions had deteriorated through mismanagement, irregular practices, and excessive risk taking.

the government. Before the incident, the regulators were already concerned about the lack of corporate governance compliance and the increasing risk of poor illiquidity of the bank's assets, but they lacked the clout to force the bank's management to reduce the bank's overall riskiness. For instance, the bank's chairman maintained an excessive risk appetite and violated the single borrower limit by authorizing 22.5% of the bank's capital fund to be loaned to *Vanik Incorporation Limited* (Abeysinghe, 2015). Dilhani (2005) lists the deficiencies of the Sri Lankan corporate governance system and emphasizes that managers did not assume their fiduciary responsibilities, auditors lacked a critical attitude, and institutional investors did not monitor the bank. Randeniya (2004) adds that bank failures result from an abuse of power by controlling owners who manage to obtain large loans on favorable terms.

*Golden Key Credit Card Company* also showcases how insufficient monitoring can be a value destroyer, especially for the minority shareholders. The firm was a fully owned subsidiary of the *Ceylinco group* which was the spider in the web of around 300 subsidiaries. Consequently, the downfall of *Golden Key* affected the entire business group. The cascade of failures was induced by the pyramidal controlling ownership structure in the group. The firm's business model was also problematic because most of the short-term funds of the company were invested in long-term capital projects (investments in real estate and construction). While the company was vulnerable to the effects of the global financial crisis, the top management enjoyed a luxurious life (with corporate money). The independent auditors failed to identify the firm's earnings manipulation. Board meetings had not been held for many years. Similar to the *Pramuka Bank* case, the failure of *Golden Key* affected depositors and created a public outcry.

We also observe the costs of poor internal and external monitoring in the failure of *Central Investment & Finance (CIFL)*. In 2012, the company announced big losses and admitted non-compliance to the minimum liquid asset threshold. Although the auditors had highlighted serious financial and corporate governance issues prior to the failure, their requests that including the appointment of an independent property valuer and the provision of audit evidence on directors' interests in company contracts, were rejected by the management. In addition, the monitoring by the board was functioning poorly. The CIFL had appointed a controversial slate of board members, most of whom belonged to a leading family or the corporate network of the company. Apart from pernicious nepotism, other corporate governance flaws were visible, such as poor incentive design of manager compensation contracts. Executive directors were insufficiently incentivized to align corporate decisions with the interest of shareholders. While the Central Bank was severely criticized for not acting to address these problems in a timely manner, it finally canceled the company's license and initiated the liquidation process in 2018.

Another example with problematic corporate governance is *PC House*, the largest computer retailer. The CEO, who also exerted the role of the chairman, was able to force board members to agree with his decisions. Frequent director turnover, family dominance, and board decision opacity were the major governance problems. In 2013, five directors left the firm, and four new ones were appointed. The leading family had two members on the board, one of whom was the founding chairman/CEO. Out of eight directors, only two were truly independent. Shareholder

**Table 8** Financial scandals and business failures

| Year | Failure case | Remarks |
|---|---|---|
| **Financial firms** | | |
| 2002 | Pramuka Savings and Development Bank | Savings and development bank that did not offer the services of a commercial bank. It failed to satisfy regulatory requirements such as minimum capital holdings, asset liquidity, and single borrower limit (i.e. maximum lending for a single borrower) |
| 2008 | Golden Key Credit Card Company | Belonging to the *Ceylinco group*, the company was not a licensed finance company, but accepted deposits and issued credit cards. It did not maintain audited financial statements; its reported financial statements were subject to window-dressing, it committed earnings manipulation, and there was evidence of managerial expropriation |
| 2008 | Seylan Bank | The *Golden Key* debacle adversely affected *Seylan Bank*, which also belonged to the *Ceylinco group*. Because of the affiliations with *Golden Key*, *Seylan Bank's* customers started deposit withdrawals which led to its downfall. The Central Bank brought the bank under the management of a state-owned bank until its recovery |
| 2018 | Central Investment and Finance | A licensed finance company that encountered serious liquidity issues and suffered from non-compliance with the Central Bank regulations. Adequate disclosure and sufficient audit evidence were not provided about directors' interests in company contracts |
| 2018 | Standard Credit Finance Limited | Belonging to the *Ceylinco group*, the company was a licensed finance company that has faced a severe liquidity crisis since 2008. It was subject to mismanagement, fraudulent activities, and family dominance (within the *Ceylinco group*) under a pyramidal structure |
| 2019 | TKS Finance Limited | A licensed finance company that continually violated the provisions of the Finance Business Act. It was in a weak financial condition because of capital inadequacy, poor asset quality, losses, and the inability of releasing funds on-demand |
| 2020 | ETI Finance Limited | A licensed finance company falling under the *EAP holdings,* which was a family-controlled entity. It was primarily engaging in money lending with gold securities as collateral, and encountered problems related to capital adequacy, illiquidity, mismanagement, and fraud |
| 2020 | Swarnamahal Financial Services | Within the *EAP holdings*, *Swarnamahal* was a quoted finance company controlled by *ETI finance limited*, a non-listed firm. Its operations were suspended because of weak financial condition, lack of a viable recovery plan, and mismanagement by family directors |
| 2020 | The Finance Company | Belonging to the *Ceylinco group*, *The Finance Company* was one of the oldest finance companies in Sri Lanka, established in 1940. The crisis in the *Ceylinco group* in 2008 led to serious liquidity problems |

**Table 8** (continued)

| Year | Failure case | Remarks |
|---|---|---|
| **Non-financial firms** | | |
| 2013 | Pelwatte Sugar Industries | A sugar-growing and manufacturing company that delisted from the stock exchange. The commercial high court issued a winding-up order. The firm did not follow the regulatory requirements |
| 2014 | Touchwood Investments | A planter of *Mahogany* plantations, was a family business in which both chairman and CEO were family members, and the chairman was the largest shareholder. It displayed a poor internal control system with regard to cash management and related-party transactions |
| 2015 | PC House | The failure of *PC House*, the largest retailer of computers, was caused by weak governance practices. The chairman and founder and the CEO (who owned 56% of the equity) undermined the role of directors in decision-making, which resulted in a lack of monitoring |
| 2015 | Orient Garments | *Orient* was engaging in manufacturing and exporting apparel, and had affiliations with *PC House* and *PC Pharma* (i.e. the next failure case). The largest shareholder/director presented a petition to the commercial high court for compulsory winding-up because of serious working capital problems |
| 2018 | PC Pharma | Affiliated with *PC House*, *PC Pharma* was operating in the drugs wholesale industry. It was delisted from the stock exchange due to the non-submission of financial statements and incompliance with listing rules and accounting standards. The auditor refused to sign the financial statements |
| 2020 | MTD Walkers | An engineering and infrastructure company against which the SEC is to take action following the default on payments on a debenture issue, the non-submission of financial statements, the alleged sale of assets, siphoning off funds, and breaching listing rules. Banks have initiated actions to recover Billions of overdues |

*Source* Colombo Stock Exchange (2021), Central Bank, and Companies Annual Reports

This table summarizes some financial and non-financial business failure incidents since 2002. Some of these firms have already been declared bankrupt, others are still in a liquidation process or continue suffer from financial constraints. Some non-bank financial institutions are forced to resort to M&As under the financial sector consolidation plan of the Central Bank monitoring was lacking because the leading family held majority ownership. In 2014, the firm became insolvent, and the auditor refused to publish an audit report.

*Touchwood Investments* was a plantation company that was family-owned and -managed and leased plant plots to investors. Corporate transparency and supervisory independence was lacking; e.g. one of the partners of the external auditor company was appointed as a member of the management team and, subsequently, as an independent director and chairman of the audit committee. Moreover, the firm had a weak internal control system of the cash management and related-party transactions. The directors' shareholdings amounted to 26%, of which the founding chairman and largest shareholder held 16%. The losses accumulated to USD 2.5 million, and the commercial high court issued a winding-up order in 2014.

There is considerable empirical evidence in Sri Lanka confirming that good governance practices enable a firm to avoid financial distress and bankruptcy. Lakshan and Wijekoon (2012) test the predictive ability of corporate governance on corporate bankruptcy by matching failed and successful firms. They conclude that the presence of independent directors and an audit committee, as well as remuneration contracts that reward the management for value creation are all negatively related to the likelihood of corporate failure. Jayasinghe and Kumara (2020) add that long CEO tenure, incentive-based managerial remuneration contracts, strong ownership concentration, and a large board also negatively affect the probability to end up in bankruptcy.

## 9 A research agenda on corporate governance in South Asia

Our survey study on Sri Lankan and South Asian corporate governance suggests some interesting directions for future research. We emphasize three important research themes that related to corporate governance in the context of South Asia: (i) corruption, (ii) business ethics, and (iii) political connections (whereby we also focus on transnational involvement: the role of China and India in South Asian countries' government development).[49]

### 9.1 Corporate governance and corruption

The case of Sri Lanka demonstrates that international shareholders can use their power to punish poorly governed firms in developing economies. As shown above, Sri Lanka has a very shallow equity market with few companies listed and few initial public offerings, the market for corporate control is limited and hence does not exert much disciplinary value, and the country was able to attract only a limited amount of foreign direct investment. As many development economists argue, corruption and ill-functioning institutions are at the heart of the lagging economic growth (Acemoglu et al., 2005). We believe that the finance and the economic

[49] For a discussion on a research agenda for developing and emerging economies in Asia, one can also consult Filatotchev et al. (2013) and Oehmichen (2018).

development-literature that takes a supply side perspective can help to expose corporations as facilitators of corruption and political nepotism.

As shown by Sri Lanka's 2022 financial and humanitarian crisis, the weak constraints on the country's political and business elites hampered the effectiveness of corporate governance reforms. Crises cannot only be explained by global market conditions such as price fluctuations in the commodity markets, but can be amplified by governmental mismanagement of macroeconomic policies. Most of the time, financial crises in developing countries are the manifestation of deeper institutional and political problems as pointed out by many scholars in the developing economics literature. For instance, Acemoglu and Johnson (2003) and Acemoglu and Robinson (2012) document that such crises in history have been associated with the existence of extractive institutions in which political and business elites expropriate countries' public and private resources and eventually shackle the economic growth potential.

Further documentation on how business elites (managers and wealth families) preserve their own interests and expropriate value that belongs to (minority) shareholders is important such that this behavior can be stopped by means of better regulation or enforcement thereof. Also interesting is whether the degree of expropriating and entrenchment behavior differs across the business cycles (market downturns vs surges)? Examining managerial behavior during crises would be interesting to showcase the relations between corporate governance and economic (in)stability. Financial history research has shown that managers expropriate even more during the crisis periods, especially in countries where corporate governance is weak. For instance, Mitton (2002) studied the impact of corporate governance across Korean, Malaysian, the Philippine, Indonesian, and Thai companies during the 1997–1998 Asian crisis and demonstrated that firms with value-oriented corporate governance mechanisms in place performed much better, and that minority shareholder expropriation was also attenuated in such a setting.

Another point of departure for future research is an analysis of shareholder and creditors rights in the region of South Asia. This Sri Lankan paper suggests above that regulatory corporate reform failed to reach the larger segment of Sri Lankan firms. A larger data set from the South Asian countries could enable us to find out whether such problems extend to the whole region and investigate to what extent shareholder and credit protection matter more or less in a context of diversity of ethnicities, religions, and societal casts. As observed for several former British colonies, such as India and Kenya, merely imitating UK based institutions has not been a sufficient condition for prosperity and economic stability. Social norms can also conflict with legal ones, and the presence of a comprehensive legal system is toothless in a setting of low enforcement (Acemoglu & Jackson, 2017).

Furthermore, it would also be interesting to study whether the voluntary adoption of international codes of conduct and international regulations by South Asian firms (even though this may not be binding in their countries) positively impacts trust in corporate contracts, and leads to a reduction of corruption. When firms adopt the global standards embedded in international governance codes of conduct, the less likely they may engage in corrupt relations with local and federal authorities (e.g., the need to make donations to political parties in government, provide employment to the family or constituents of politicians in exchange for government contracts or loans from government-related banks) (Anastasiadis et al., 2018).

When governments of developing countries fail to implement imperative regulations, firms may seek private solutions to signal their quality to access new markets and to earn the trust of international investors in order to attract external funds at a lower cost of capital. Such firms can go beyond the regulation on social issues or climate change, and improve their ESG scores by enhancing employee engagement, observing human rights, and reducing pollution. Still, if such corporate policies take place on a voluntary basis, they are less effective than public policies imposed by the governments on the whole population of firms (Boateng et al., 2021; Vogel, 2010). A cautionary note emerging from our analysis is that any study in this field ought to consider a country's socio-cultural factors and institutional context.

International investors have become concerned about investing money ethically. ESG-focused or socially responsible investment funds, which require a firm to adopt policies to safeguard the environment, stimulate the firm's social orientation (e.g. employee engagement, respect for human rights), and strive for more inclusiveness, make up a significant part of world capital investments (Ferrell et al., 2016; Liang & Renneboog, 2017). Ethical investors focus on well-governed firms that prioritize on accountability, transparency, and other practices with a moral dimension. Some of the sovereign wealth funds are among the biggest players of the ESG market. For instance, the Norwegian Oil Fund (the Government Pension Fund Global) is the largest sovereign fund of the world with a value exceeding a trillion USD (in 2022) and counts itself as a pioneer in the responsible investing worldwide and an ESG activist. It follows an extensive ESG screening protocol (on children's rights, climate change, water management, human rights, transparency, corruption, sustainability, biodiversity, etc.) and uses its equity investments as a lever to direct corporate policies towards more corporate social responsibility. Although firms in developing economies often do not yet sufficiently meet sustainability criteria, pressure from ethical money accumulated in the Global North could bring about corporate changes and consequently lower the cost of capital to firms improving both their corporate governance practices and adopting an ESG policy.

### 9.2 Corporate governance and business ethics

We argue that the role of informal institutions—such as family, ethnic, linguistic or religious ties, and social norms – deserves more of researchers' attention to better understand the trajectory and the current state of corporate governance in South Asia. It is interesting to examine how different ethical and cultural perspectives affect managerial behavior, financial decision making, and the functioning of corporate boards. Such studies will be complementary to the extant literature on the impact of formal institutions and regulation on economic development (Acemoglu & Johnson, 2003; La Porta et al., 2000). Moreover, transnational cultural ties may also matter. For instance, in the context of Sri Lanka, we observe that Indian entrepreneurs invest more in the northern part of the country where the (Indian) Tamil population lives, whereas Chinese investors direct their resources to the south of the country where (Buddhists) Sinhala population reside. This may imply that managers and other business elites' cultural identities and social ties may play non-negligible role on external financing. However, such relations also dependent on the geo-political agendas of the regional powers, India and China.

Historically, the social stratification in South Asia plays a large role not only in people's social interactions but also in their economic activities. The prevailing caste system, and ethno-linguistic and religious plurality can bring social tension and conflicts. While social norms and values that foster segregation only change very slowly, corporations may well manage to create more inclusive corporate cultures (Guiso et al., 2015). For instance, the Sri Lankan corporations able to create an inclusive working environment have reaped the benefits of such efforts. For instance, Nazliben et al. (2022) showed that ethnically and linguistically well-diversified Sri Lankan corporate boards have significantly improved firm performance. It is interesting to research whether the successes of corporate inclusion in Sri Lanka can be extrapolated to other South Asian countries that are characterized by large cultural diversity and simmering conflicts (such as India).

As little is known in the South Asian governance literature on managerial remuneration contracting, an interesting study could be made about managerial pay controlling for a manager's education, skills, experience, gender, social qualities and cultural background (i.e., ethnicity, religion, nationality, and gender).

### 9.3 The influence of the politics

As shown above, corporations are neither immune to internal socio-economic dynamics nor to external political forces. For instance, Sri Lanka's economic development is affected by some major economic powers: India, China, and the Western countries, among which complicated and sometimes conflicting geo-political relations exist. At the country level, during the 2022 financial crisis, both China and India assisted Sri Lanka by providing liquidity, opening new credit lines, deferring coupon payments, as well as help in purchasing medicines and food. Considering the growing economic and political influence of China and India in the whole of South Asia, corporations in this region may have to adjust their way of doing business, their governance system, and legal and ethical traditions. As firms from both countries aim at increasing their political and economic influence, they may seek to increase ownership and controlling stakes in strategical sectors. For example, the Indian investment group, Adani Group of India, acquired 51% of the Sri Lanka's Colombo Port and invested in several large-scale energy projects during 2021–2022. In the same period, Lanka Indian Oil Corporation held 49% of Sri Lanka's recently established Trinco Petroleum Terminal Pvt Ltd. Chinese companies are the biggest foreign direct investors in Sri Lanka and also direct their resources towards strategic industries such as logistics, infrastructure, and utilities. For example, China Communications Construction Company Ltd invested USD 1.4 billion in Sri Lanka in 2014. Its investments in the Colombo Port City project gave the company control over part of the port in a way that it is de facto a sovereign Chinese territory. Also, China Harbour Engineering Company Ltd made sizable investment on the variety of infrastructure projects during 2017–2022. When providing debt financing, Chinese and Indian (state-owned) banks may be motivated by national political agendas (Paul, 2019).

## 10 Conclusion

As in many corporations around the world, agency problems between management and shareholders, or between different types of shareholders are also prominent in Sri Lankan firms. Shareholders may lose value to a self-interested management, especially in a context of dissipated ownership (and hence lack of monitoring shareholders) and of weak corporate boards. Furthermore, in companies with strong ownership concentration held by e.g. family, minority shareholders' rights may be expropriated. In Sri Lanka, many business groups are controlled by families and individuals who maintain voting power by means of ownership pyramids, cross-holdings, or intermediate investment vehicles. Although the country has a modern legal system and corporate governance code, law enforcement is not sufficiently effective to protect (minority) shareholders' rights. Although Sri Lanka is a bank-based economy, the legal protection of creditors is poor. In addition, firms' widespread use of political connections can force banks, in which the state often holds an equity stake, to accept wealth transfers to companies by granting credit on favorable terms.

While firms claim to adopt corporate social responsibility goals, it seems that they are paying lip service to environmental, social and governance issues. Although the country has laws on labor protection, environmental protection, the appointment of directors, and management based on gender and ethnolinguistic inclusion criteria, many incidents occur of labor rights violations (e.g., gender-pay-gap, child labor, prohibition of labor unions, dismissal of union leaders, etc.), and pollution. One rightfully worries about the extent to which firms use their ESG commitments for greenwashing.

In terms of policy suggestions, this paper has argued for the implementation of stricter controls on the corporate governance regulation and code of conduct. For instance, in a country that has been torn by civil war for almost 30 years, the implementation of board diversity, not just in terms of directors' qualifications, skills, and experience, but also in terms of ethnicity, knowledge of the local languages, and gender is of utmost important as firms' sensitivity toward ethno-linguistic and religious minority groups needs to be stimulated. Furthermore, truly independent non-executives need to be appointed rather than directors who are related or connected to dominating shareholder-families. Transparency of related-party transactions is key to expose conflicts of interest that may lead to tunneling, a real possibility given the corporate interconnectedness of firms in business groups. In order to limit large shareholders' expropriation of minority shareholders, the existing legal and institutional framework need to be strengthened, and effective law enforcement should be assured. Further arrangements should be made to guarantee the quality of the internal audit committee as well as the appointment of independent external audit firms. This development is also essential if the country is to attract more foreign direct investments.

As political connections play an important and often harmful role in the corporate sector, firms could benefit from a legal ban of politically connected directors, e.g., banning directors with a current or past position in government, parliament, or the civil service. As a consequence, the direct and indirect extraction of corporate resources by government bodies or political parties for their own benefit or that of their voters/members. Firms may also be exposed to the capture of corporate resources by banks, who are the main providers of funds.

We observe that although the strengthening of the corporate governance regulations have contributed to mitigating agency conflicts in Sri Lankan firms, agency problems, corruption, and political connections still prevail. A considerable part of the economy is controlled by business groups, which usually consist of a holding company with listed and private subsidiaries. The holding company then exerts the control over the other firms of the group, and the largest shareholder of the holding company is usually an individual or family. Agency problems, the expropriation of the rights of minority shareholders (through transfer pricing or tunnelling), hidden intercompany loans, masked externalities (such as pollution) could be present in business groups. More research on such business groups as well as on private firms (who hardly disclose any information) could further contribute to gaining more insight in the economic maze and engender important policy changes.

## Appendixes

### Appendix 1: Public governance indicators

This table shows public governance indicators of a sample of countries for 2021. The rule of law index captures the extent to which people are satisfied with the rules of society, quality of execution of contracts, property rights and judicial system (police and courts), and fight against crime and violence. The political stability index focuses on government stability in the context of illegitimate phenomena such as violence and terrorism. The regulatory quality index measures how effective a government is when setting policies and regulations to encourage private sector development. The control of corruption index concerns the extent to which public power is enforced such that private returns can be generated; the index captures the degree of corruption in society. The voice and accountability index measures the extent to which citizen's freedom to participate in selecting the government, to express ideas, and to form associations, and the presence of a free media. These indices range from − 2.5 (weak) to + 2.5 (strong)

| Country | Rule of law (− 2.5 to + 2.5) | Regulatory quality (− 2.5 to + 2.5) | Political stability (− 2.5 to + 2.5) | Corruption control (− 2.5 to + 2.5) | Voice and accountability (− 2.5 to + 2.5) |
|---|---|---|---|---|---|
| *Advanced economies* | | | | | |
| USA | 1.42 | 1.45 | 0.00 | 1.05 | 0.90 |
| Germany | 1.61 | 1.63 | 0.76 | 1.81 | 1.43 |
| *Financial hubs* | | | | | |
| Hong Kong | 1.45 | 1.58 | 0.26 | 1.71 | − 0.21 |
| Singapore | 1.86 | 2.23 | 1.49 | 2.17 | − 0.14 |
| *Mature markets* | | | | | |
| Japan | 1.58 | 1.38 | 1.03 | 1.57 | 1.08 |
| South Korea | 1.13 | 1.10 | 0.66 | 0.76 | 0.93 |
| Australia | 1.67 | 1.84 | 0.85 | 1.74 | 1.38 |
| *Growing Giants* | | | | | |
| China | 0.04 | − 0.31 | − 0.48 | 0.05 | − 1.64 |
| India | − 0.08 | − 0.08 | − 0.62 | − 0.29 | 0.11 |
| *Emerging countries* | | | | | |
| Indonesia | − 0.22 | 0.30 | − 0.51 | − 0.43 | 0.16 |
| Thailand | 0.11 | 0.09 | − 0.55 | − 0.46 | − 0.79 |
| Malaysia | 0.56 | 0.72 | 0.14 | 0.17 | − 0.15 |
| Philippines | − 0.64 | 0.08 | − 0.93 | − 0.51 | − 0.15 |
| **Sri Lanka** | **0.04** | **− 0.37** | **− 0.32** | **− 0.33** | **− 0.07** |

*Source* World Bank (2022)

## Appendix 2: Shareholder and creditor protection

This table compares shareholder, minority shareholder, and creditor protection of a selection of countries for 2020. The shareholder rights index captures the need for shareholders' approval when a firm intends to sell a major part of assets, the shareholders' ability to call a shareholder meeting, the requirement to solicit their approval for doing new equity issues, the degree to which they receive preemption rights on new equity issues, the power of electing and dismissing external auditors, and the need for shareholder approval for changing their rights. The minority investor protection index accounts for the extent to which minority shareholders are protected against expropriation of firm resources by major shareholders, and for the strength of shareholder rights, governance assurance, and business transparency that can potentially reduce the risk of expropriations. The creditor rights index stands for the presence of stronger credit recording systems, the effectiveness of legal conditions to protect collateral, and the treatment of creditors in the event of liquidation

| Country | Shareholder Rights Index (0–6) | Minority Investor Protection Index (0–50) | Creditor Rights Index (0–12) |
|---|---|---|---|
| *Advanced economies* | | | |
| USA | 2 | 36 | 11 |
| Germany | 5 | 31 | 6 |
| *Financial hubs* | | | |
| Hong Kong | 5 | 42 | 8 |
| Singapore | 5 | 43 | 8 |
| *Mature markets* | | | |
| Japan | 4 | 32 | 5 |
| South Korea | 4 | 37 | 5 |
| Australia | 4 | 32 | 11 |
| *Growing giants* | | | |
| China | 5 | 36 | 4 |
| India | 6 | 40 | 9 |
| *Emerging countries* | | | |
| Indonesia | 5 | 35 | 6 |
| Thailand | 5 | 43 | 7 |
| Malaysia | 5 | 44 | 7 |
| Philippines | 1 | 30 | 1 |
| **Sri Lanka** | **5** | **36** | **2** |

*Source* Doing Business Project of the World Bank (2022)

## Appendix 3: Financial development

This table reports financial development indicators of a selection of countries for 2020. Overall financial development (captured by the financial development index) comprises financial institutional development and financial market development indices. Each of these sub-indices is further divided into three more sub-indices consisting of the depth of services, accessibility, and efficiency of financial institutions as well as financial markets

| Country | Financial Development | Financial Institutional Development | | | | Financial Market Development | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | Total | Depth | Access | Efficiency | Total | Depth | Access | Efficiency |
| *Advanced Economies* | | | | | | | | | |
| USA | 0.91 | 0.88 | 0.83 | 0.84 | 0.65 | 0.90 | 0.99 | 0.66 | 1.00 |
| Germany | 0.75 | 0.69 | 0.66 | 0.61 | 0.54 | 0.78 | 0.76 | 0.57 | 0.98 |
| *Financial Hubs* | | | | | | | | | |
| Hong Kong | 0.78 | 0.79 | 1.00 | 0.46 | 0.61 | 0.74 | 0.80 | 0.77 | 0.62 |
| Singapore | 0.70 | 0.73 | 0.96 | 0.32 | 0.70 | 0.64 | 0.82 | 0.82 | 0.20 |

| Country | Financial Development | Financial Institutional Development | | | | Financial Market Development | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | Total | Depth | Access | Efficiency | Total | Depth | Access | Efficiency |
| *Mature Markets* | | | | | | | | | |
| Japan | 0.93 | 0.95 | 0.89 | 0.88 | 0.72 | 0.86 | 0.93 | 0.62 | 1.00 |
| South Korea | 0.83 | 0.86 | 0.89 | 0.66 | 0.72 | 0.78 | 0.82 | 0.48 | 1.00 |
| Australia | 0.91 | 0.90 | 0.86 | 0.79 | 0.73 | 0.89 | 0.96 | 0.76 | 0.88 |
| *Growing Giants* | | | | | | | | | |
| China | 0.67 | 0.62 | 0.50 | 0.49 | 0.74 | 0.70 | 0.71 | 0.37 | 1.00 |
| India | 0.52 | 0.42 | 0.38 | 0.26 | 0.56 | 0.59 | 0.64 | 0.20 | 0.93 |
| *Emerging Countries* | | | | | | | | | |
| Indonesia | 0.31 | 0.23 | 0.09 | 0.10 | 0.58 | 0.38 | 0.19 | 0.37 | 0.59 |
| Thailand | 0.74 | 0.72 | 0.64 | 0.62 | 0.68 | 0.73 | 0.75 | 0.41 | 1.00 |
| Malaysia | 0.73 | 0.69 | 0.83 | 0.35 | 0.71 | 0.74 | 0.95 | 0.48 | 0.70 |
| Philippines | 0.37 | 0.36 | 0.20 | 0.24 | 0.67 | 0.37 | 0.58 | 0.33 | 0.15 |
| **Sri Lanka** | **0.26** | **0.37** | **0.15** | **0.29** | **0.69** | **0.15** | **0.09** | **0.24** | **0.13** |

*Source* Financial Development Index Database of the International Monitory Fund (2022)

## Appendix 4: Overview of the Sri Lankan economy

### Appendix 4.1: Economic growth and development of Sri Lanka, South Asia, and OECD countries

This table compares economic and social indicators of south Asian and OECD countries for 2021. The unemployment rate is presented as a percentage of the total labor force. GDP growth is the annual percentage growth rate of Gross Domestic Product (GDP) at market prices in constant 2010 USD. GDP per capita is calculated as GDP scaled by the midyear population. The gross domestic (GD) savings, foreign direct investment (FDI) net inflows, current account balance, and fiscal balance are stated as a percentage of the GDP. GD savings are calculated as GDP minus total consumption. FDI net flow is the difference between new investment inflows from foreign investors and disinvestment. The current account balance is the sum of net exports (difference between export and import of goods and services), net primary income, and net secondary income. Fiscal balance is the sum of government tax revenue and proceeds from asset sales, minus government expenditures. Inflation is measured as the annual percentage change of the consumer price index. *, ** indicate that data is available only for 2019 and 2020, respectively

| Indicator | South Asia and OECD Country Comparison (2021) | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Afghanistan | Bangladesh | Bhutan | India | Maldives | Nepal | Pakistan | Sri Lanka | OECD |
| Population (mn) | 40.10 | 169.36 | 0.78 | 1410.00 | 0.52 | 30.03 | 231.40 | 22.16 | 1370.00 |
| Unemployment (%) | 13.30 | 5.20 | 4.30 | 6.00 | 6.10 | 5.10 | 4.40 | 5.40 | 6.30 |
| GDP growth (%) | – 20.70 | 6.90 | 4.10 | 8.70 | 41.70 | 4.20 | 6.50 | 3.30 | 5.40 |
| GDP per capita ($) | 368.80 | 2457.90 | 3266.40 | 2256.60 | 10,366.30 | 1208.20 | 1505.00 | 4013.70 | 42,446.90 |
| GD Savings (%) | – 20.40** | 25.30 | 14.90 | 29.30 | 47.00 | 7.70 | 5.70 | 27.90 | 22.70 |
| FDI net inflow (%) | 0.10 | 0.30 | 0.10 | 1.40 | 8.20 | 0.50 | 0.60 | 0.70 | 1.90 |
| Current account (%) | – 15.50** | – 3.70 | – 12.70 | – 1.10 | – 8.50 | – 14.8 | – 3.50 | – 4.00 | – 0.10** |
| Fiscal balance (%) | – 4.30** | – 5.20 | – 6.30 | – 12.30** | – 16.65 | – 2.37 | – 7.10 | – 12.20 | – 3.20* |
| Inflation (%) | 5.60** | 5.50 | 7.30 | 5.10 | 0.50 | 4.10 | 9.50 | 7.00 | 2.80 |

*Source* World Bank (2022), Asian Development Bank (2022), and OECD (2022)

## Appendix 4.2: Stock market performance

This table shows the stock market performance of the Colombo Stock Exchange. There are two price indexes: All Share Price Index (ASPI) and the S&P Sri Lanka 20 Index (S&P SL20). The ASPI is broader as it captures the movements of the whole market; the S&P SL20 reflects the performance of the 20 largest and most liquid companies

| | Stock Market Performance: 2015–2021 | | | | | |
|---|---|---|---|---|---|---|
| Year | Firms | Turnover (Rs. mn) | Daily Average Turnover (Rs. mn) | Market Capitalization (Rs. bn) | ASPI (1985 = 100) | S&P SL20 (2004 = 1000) |
| 2015 | 294 | 253,251.00 | 1060.00 | 2938.00 | 6894.50 | 3625.70 |
| 2016 | 295 | 176,935.00 | 737.00 | 2745.40 | 6228.30 | 3496.40 |
| 2017 | 296 | 220,591.00 | 915.00 | 2899.30 | 6369.30 | 3671.70 |
| 2018 | 297 | 200,069.00 | 834.00 | 2839.50 | 6052.40 | 3135.20 |
| 2019 | 289 | 171,408.00 | 711.00 | 2851.30 | 6129.20 | 2937.00 |

| Year | Stock Market Performance: 2015–2021 | | | | | |
|---|---|---|---|---|---|---|
| | Firms | Turnover (Rs. mn) | Daily Average Turnover (Rs. mn) | Market Capitalization (Rs. bn) | ASPI (1985 = 100) | S&P SL20 (2004 = 1000) |
| 2020 | 283 | 396,882.00 | 3217.00 | 2960.70 | 6774.20 | 2638.10 |
| 2021 | 296 | 1,173,157.00 | 4888.00 | 5489.20 | 12,226.00 | 4233.30 |

*Source* Central Bank of Sri Lanka (2021)

## Appendix 5: Initial public offerings

This table summarizes the Initial Public Offerings (IPOs) launched from 2014 to mid-2021. The IPOs are *Amana Bank (ABL), Millennium Housing Developers (MHDL), Alumex (ALUM), Adam Investments (AINV), Lucky Lanka Milk Processing Company (LLMP), Arpico Insurance (AINS), Singhe Hospitals (SINH), People's Insurance (PINS), Orient Finance (BFN), Amana Takaful Life (ATLL), B P L Holdings (BPPL), R I L Property (RIL), Jetwing Symphony (JETS), LVL Energy Fund (LVEF), Laugfs Power (LPL), HNB Finance (HNBF), Windforce Limited (WIND), Chrissworld Limited (CWL), and Prime Lands Residencies Limited (PLR).* Initial return and long-run return are continuously compounded returns by considering respectively, the IPO price and the closing price of the first trading day, and the IPO price and subsequent closing prices (3–36 months) in the long-run, i.e. [ln (Closing Price/IPO Price)]

Initial public offerings: 2014 to mid-2021

| Company | Industry | Year | Shares (mn) | IPO Price (Rs) | Initial Return % | Long-run Return % (in months) | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | 3 | 6 | 12 | 24 | 36 |
| ABL | Banks | 2014 | 235.70 | 7.00 | −17.10 | – 33.65 | – 20.54 | – 27.82 | – 41.98 | – 69.3111 |
| MHDL | Real Estate | 2014 | 16.00 | 6.00 | 4.88 | – 6.90 | – 1.68 | 23.64 | 23.64 | 13.98 |
| ALUM | Materials | 2014 | 17.80 | 14.00 | 1.42 | 0.00 | 8.88 | 12.09 | 9.53 | 30.54 |
| AINV | Diversified Financials | 2014 | 132.60 | 3.00 | 28.77 | 36.00 | 28.77 | – 6.90 | – 14.31 | – 160.94 |
| LLMP | Dairy | 2014 | 38.00 | 6.00 | 0.00 | – 16.25 | – 16.25 | – 40.55 | – 51.08 | – 91.63 |
| AINS | Insurance | 2015 | 6.60 | 12.00 | 16.13 | 15.42 | 25.59 | 8.00 | 5.67 | 36.00 |
| SINH | Health Care | 2015 | 100.00 | 2.50 | 0.00 | – 22.31 | – 8.34 | – 12.78 | – 32.85 | – 38.56 |
| PINS | Insurance | 2016 | 50.00 | 15.00 | – 0.67 | 16.55 | 11.33 | 23.64 | 40.99 | 23.64 |
| BFN | Diversified Financials | 2016 | 71.50 | 15.00 | 1.98 | – 12.03 | 9.53 | – 24.85 | 27.26 | – 3.39 |
| ATLL | Insurance | 2016 | 50.00 | 1.50 | 18.23 | – 51.08 | – 91.63 | – 62.86 | 166.14 | 126.22 |

| Initial public offerings: 2014 to mid-2021 | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Company | Industry | Year | Shares (mn) | IPO Price (Rs) | Initial Return % | Long-run Return % (in months) | | | | |
| | | | | | | 3 | 6 | 12 | 24 | 36 |
| BPPL | Household & Personal Products | 2017 | 30.70 | 12.00 | 3.28 | 25.59 | 19.61 | 8.00 | – 17.24 | – |
| RIL | Retailing | 2017 | 120.00 | 8.00 | 4.88 | – 1.26 | – 10.54 | – 9.16 | – 25.49 | – |
| JETS | Consumer Services | 2018 | 50.20 | 15.00 | 0.66 | – 12.78 | – 19.04 | – 22.31 | – 31.02 | – |
| LVEF | Utilities | 2018 | 120.00 | 10.00 | 1.00 | – 2.02 | – 15.08 | – 18.63 | – 30.11 | – |
| LPL | Utilities | 2019 | 335.00 | 8.80 | – 36.64 | – 1.21 | – 2.06 | – 1.33 | – | – |
| HNBF | Bank Finance & Insurance | 2020 | 10.00 | 5.70 | – 9.18 | – | – | – | – | – |
| WIND | Power Producers & Energy Traders | 2021 | 202.60 | 16.00 | 10.66 | – | – | – | – | – |
| CWL | Industrial | 2021 | 7.50 | 7.50 | 56.53 | 112.08 | – | – | – | – |
| PLR | Real Estate | 2021 | 100.00 | 10.40 | 13.47 | – 12.17 | – | – | – | – |

*Source* Colombo Stock Exchange (2021)

## Appendix 6: Mergers and acquisitions

This table reports recent mergers (Panel A) and acquisitions (Panel B) in Sri Lanka, respectively

| Year | Target/s | Target's Industry | Bidder |
|---|---|---|---|
| *Panel A: Mergers* | | | |
| 2015 | DFCC Bank, and DFCC Vardhana Bank | Financial | DFCC Bank Plc |
| 2015 | MCSL Financial Services Ltd, and | Financial | Merchant Bank of Sri Lanka Plc |
| | MBSL Savings Bank | | |
| 2017 | Chilaw Finance Plc | Financial | Richard Pieris Finance Ltd |
| 2018 | LOLC Micro Credit Ltd | Financial | LOLC Finance Plc |
| 2019 | Etisalat Lanka Ltd | Telecommunication | Hutch (Sri Lanka) Ltd |
| 2021 | Sinhaputhra Finance Plc | Financial | Commercial Leasing & Finance Plc |
| 2022 | Commercial Leasing & Finance Plc | Financial | LOLC Finance Plc |
| 2022 | LOLC Development Finance Plc | Financial | LOLC Finance Plc |

| Year | Target/s | Target's Industry | Bidder |
|---|---|---|---|
| 2022 | Alco Industries Ltd | Materials | Alumex Plc |
| 2023 | Pearl Springs Ltd | Food Beverage & Tobacco | Lion Brewery (Ceylon) Plc |
| 2023 | Singer Digital Media Ltd | Retailing | Singer (Sri Lanka) Plc |
| *Panel B: Acquisitions* | | | |
| 2015 | Ambeon Capital Plc | Consumer Durables & Apparel | CHC Investment Ltd |
| 2016 | Distilleries Company of Sri Lanka Plc | Food Beverage & Tobacco | Melstacorp Plc |
| 2016 | Browns Hydro Power Plc | Utilities | Lotus Renewable Energy Ltd |
| 2017 | Balangoda Plantations Plc | Plantation | Melstacorp Plc |
| 2017 | Madulsima Plantations Plc | Plantation | Melstacorp Plc |
| 2017 | Singer (Sri Lanka) Plc | Retailing | Hayleys Plc |
| 2018 | Janashakthi General Insurance Ltd | Insurance | Allianz Insurance Lanka Ltd |
| 2019 | Brown and Company Plc | Capital Goods | LOLC Holdings Plc |
| 2019 | Hunas Falls Hotels Plc | Consumer Services | Serenity Lake Leisure (Private) Ltd |
| 2019 | Hatton Plantations Plc | Food Beverage & Tobacco | Lotus Renewable Energy Ltd |
| 2019 | Citrus Leisure Plc | Consumer Services | George Steuart & Company Ltd |
| 2021 | Panasian Power Plc | Utilities | RIL Property Plc |
| 2021 | Prime Finance Plc | Financial | HNB Finance Plc |
| 2022 | Multi Finance Plc | Financial | LB Finance plc |
| 2022 | AgStar Plc | Materials | ICONIC Trust Ltd |

*Source* Colombo Stock Exchange (2023)

## Appendix 7: Employee share option schemes

This table presents recently launched Employee Share Option Schemes (ESOSs) by Sri Lankan listed firms and the number of shares created through ESOSs

| Company | Industry | Year of Shares Listed | Shares |
|---|---|---|---|
| Commercial Bank of Ceylon | Banks | 2019 | 293,385 |
| Hemas Holdings | Capital goods | | 1000 |
| John Keells Holdings | Capital goods | | 285,090 |
| John Keells Holdings | Capital goods | | 245,471 |
| Dialog Axiata | Telecommunication services | | 30,030,700 |
| Cargills (Ceylon) | Food & staples retailing | 2020 | 88,621 |
| Hemas Holdings | Capital goods | | 62,200 |
| Teejay Lanka | Consumer durables & apparel | | 7,365,965 |
| Vidullanka | Utilities | | 4,166,323 |

| Company | Industry | Year of Shares Listed | Shares |
|---|---|---|---|
| Cargills (Ceylon) | Food & staples retailing | 2021 | 4836 |
| Hemas Holdings | Capital goods | | 314,650 |
| Vidullanka | Utilities | | 1,468,452 |
| Commercial Bank of Ceylon | Banks | | 33,786 |
| John Keells Holdings | Capital goods | | 984,231 |
| John Keells Holdings | Capital goods | 2022 | 6,924,583 |
| John Keells Holdings | Capital goods | 2023 | 6,924,583 |
| Amana Bank | Banks | | 83,518,485 |

*Source* Colombo Stock Exchange (2023)

## Declarations

**Conflict of interest** The authors declare that the writing and submission of the paper is notsubject to conflicts of interest. No external sources of financing were used to write this paper.

**Human participants and/or animals** The research does not involve human participants and/or animals.



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