ROLE OF NON – EXECUTIVE DIRECTORS IN CORPORATE GOVERNANCE IN THE CONTEXT OF THE CODES ON CORPORATE GOVERNANCE

HALPEGE WALTER GUNETILLEKE

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ABSTRACT

This thesis investigates the role of the Non-Executive Directors (NEDs) of the listed companies in the Alternative Investment Market (AIM) in the UK. Literature review on general theoretical framework on corporate governance and on the role of NEDs shows that there is a paradoxical compliance, that is the implementation of the statutory and non-statutory codes on corporate governance to minimise the corporate governance problems such as exploitation of the assets of shareholders by the management, corporate collapses, accounting frauds and so on yet the same problems emerging again and again. Therefore, the re-examination of the role of NEDs was identified as the intellectual problem for this thesis.

A review into the existing research methodologies and research methods led to understand the need to design a research methodology for replication in the same research context or another research context to ensure reliability and validity of the research methodology and methods selected. Two research methods were chosen to collect data that is content analysis and postal questionnaire survey. The main theoretical framework used in this research is the Role Theory.

The goal of this research is to understand the role of the NEDs in the context of the implementation of the non-regulatory Codes on Corporate Governance. The aim is to design the research methodology only after making a review into the strengths and weaknesses of the existing research methodologies into the role of the NEDs. The objective is to execute the same with a view to identify a model on the role of NEDs useful for the corporate sector in Sri Lanka.

Thesis argues the rational of explaining the role of the NEDs in several categories such as strategy, advice, monitoring and service in previous research. This research finds a multiple number of tasks of NEDs as well as diversity among the tasks. Further it argues that the role of NEDs is conditioned by the expectations of the stakeholders as well as with their own cognitive disposition.

Thesis contributes to knowledge in number of ways namely: (1) role of NEDs in AIM companies, (2) a review of general theoretical framework on corporate governance in the context of the implementation of non-regulatory codes on corporate governance, (3) a review of corporate governance experience in Sri Lanka and (4) some methodological developments for the content analysis technique namely use of Chi square test statistics to prove the protection of two properties of content analysis that is mutual exhaustiveness and mutual exclusiveness.

Subject to several limitations arising from the inherent weaknesses in sampling and data collection, thesis certainly makes a contribution to understand the role of the NEDs in the modern corporation as well as to design a model on the role of NEDs in Sri Lanka which is planning to implement a non-regulatory code on corporate governance.

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ABBREVIATIONS

AIM	Alternative Investment Market
BOD	Board of Directors
BOE	Bank of England
CBSL	Central Bank of Sri Lanka
CEO	Chief Executive Officer
EC	Executive Chair
FSA	Financial Services Authority
FRC	Financial Reporting Council
FTSE	Financial Times Stock Exchange
IACS	International Accounting Standards Committee (IASC)
IAPC	International Standards of International Auditing Practices Committee
IASB	International Accounting Standards Board
IBSL	Insurance Board of Sri Lanka
ICASL	Institute of Chartered Accountants of Sri Lanka
NEDs	Non-Executive Directors
OECD	Organisation for Economic Cooperation and Development
PLC	Public Limited Liability Corporation
SEC	Security Exchange Commission
SLAASMB	Sri Lanka Accounting and Auditing Standards Monitoring Board
UK	United Kingdom

US	United States (of America)

Chapter I

Introduction

1.1 Research Problem

Filatotchev *et al.*, (2007) reiterate the argument of many authors (Jensen, 1993; Jones and Pollitt, 2003; Šević, 2005) that the research in corporate governance mushrooms only when there is a corporate governance crisis. Apart from the above argument, we find that although there is an extensive literature on various aspects of the role of the Board of Directors (BOD) as identified in chapter 2, but there is still a gap of understanding the nature of contribution of the Non-Executive Directors (NEDs). Authors point out the lack of research as well as argue the validity and reliability of the research methods used, sampling methods, and the ultimate objective of the research (Bourgeois, 1979; Stiles, 2001; Huse, 2005).

Research problems do not come in a vacuum. The separation of ownership and management (Fama and Jensen, 1983a and 1983b) in large public corporations demands the appointment of the NEDs into the BOD to align the interests of many stakeholders namely, the shareholders, managers, employees, suppliers and customers and many other groups (Donaldson and Preston, 1995; Jensen, 2001). However, the general opinion of the research findings is that the NEDs have failed to meet the expectations of the shareholders as well as the other stakeholders (Kesner and Johnson, 1990; Byrd and Hickman, 1992; Jensen, 1993; Useem, 2003; Dulewicz and Herbert, 2004; Belden, Fister and Knapp, 2005; Miwa and Ramseyer, 2005; Helland and Sykuta, 2005; Fich and Shivdasani, 2006). However, there is some appreciation of the contribution of NEDs to protect the interests of the shareholders mainly

(Kosnik, 1987; Rosentein and Wyatt, 1990). Authors point out the corporate governance problems damage the interests of many stakeholders creating unemployment problems and heavy burden for the tax payers (Jensen, 1993; Šević, 2005).

However, the role of the NEDs come into the focus of both policy planners and the researchers only when there is large scale corporate collapses and other times the authors go to a deep slumber (Jensen, 1993; Jones and Pollitt, 2003; Šević, 2005). Criticisms against the NEDs such as in the BOD of the failed Enron Corporation could be justifiable because of the negligence of their duties despite being the best among the NEDs, at least by the consideration of the academic credentials and the experience (Useem, 2003). This is evident enough to show that the mere qualifications or the experience alone is not sufficient to guarantee the proper discharge of the responsibilities in company law (Companies Act, 2006), if not the interests of the wider stakeholders (Donaldson and Preston, 1995; Jensen, 2001). Many factors make them effective apart from the qualifications or the experience: Concern for the legal liability of the directors (Cheffins and Black, 2006), reputational effects (Fama and Jensen, 1983a) and more opportunities on previous successes as NEDs (Ferris, Jagannathan and Pritchard, 2003; Yermack, 2004). Later in the thesis, it will show how the 'Non-Statutory Codes on Corporate Governance' (Davies, 2002:15) such as the Code of Best Practice or the Cadbury (1992) guidelines and the Combined Code on Corporate Governance, 2006[1] (FRC, 2006) and social factors influence the role of NEDs.

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[1] Gregory and Simmelkjaer (2002:11) define a Code on Corporate Governance as follows. 'Corporate governance code ... A systematically arranged set of principles, standards, best practices and/or

The governments of the countries where the corporate collapses were severe in terms of the effect on the economy and employment, mainly in the US, implemented statutory regulations (*Sarbanes-Oxley Act, 2002*), giving wider powers to the regulatory authority to regulate the corporate sector. In the UK, non-regulatory corporate governance codes were implemented started with the Cadbury (1992) guidelines[2]. Larsen and Smith (2007) in *The Financial Times* report that the UK government is considering a Code of Conduct for private equity funds, too.

Unlike in the US, the major feature of the non-regulatory codes on corporate governance is the freedom of the corporations either to comply on a voluntary basis or if not, to explain the reasons for not complying in the corporate governance report which is to be included in the annual report (FRC, 2003; FRC 2006). Majority of the companies listed in the London Stock Exchange (LSE) that is Financial Times Stock Exchange (FTSE) companies and Alternative Investment Market (AIM) companies have now accepted codes[3] on corporate governance (Dahya, McConnell and Travlos, 2002; Pass, 2004) in addition to a number of unlisted small and medium scale

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recommendations; precatory in nature; that is neither legally nor contractually binding; relating to the internal governance of corporations (covering topics such as the treatment of shareholders, the organisation and practices of (supervisory) boards and corporate transparency) and issued by a collective body'.

[2] They are: Greenbury Report on Executive Remuneration 1995; Hampel Report on Corporate Governance 1998; Combined Code 1998; Turnbull Report on Guidance for Directors on Combined Code, 1999; Myners Report on Institutional Investors, 2001; Smith Report on Audit Committees, 2003; Higgs Report on Non-Executive Directors, 2003 and the latest is the repeal of the Combined Code on Corporate Governance of 2003with the Combined Code on Corporate Governance, 2006.

[3] The Combined Code on Corporate Governance 2006 (FRC, 2006) is effective on or after 1 November 2006 and these results are in relation to the Cadbury (1992) and Combined Code on Corporate Governance, 2003 (FRC, 2003).

companies (Westhead, 1999; Deakins, O'Neill and Milliken, 2000; Berry and Perren, 2001; Corbetta and Salvato, 2004; Long, Dulewicz and Gay, 2005).

Despite the statutory regulations in the US and non-regulations in the UK, corporate governance problems still prevail as demonstrated in recent research (Chalmers, Dann and Harford, 2002; Luo, 2006; Das, 2006; Financial Crimes Report to the Public, 2006; Masters, 2007). Many ways of misappropriation of the assets of the shareholders are documented by the authors since the days of the beginning of the modern corporations (Berle and Means, 1933), to the recent times (Luo, 2006). In between these periods, expropriation of the assets of the shareholders have come in many subtle ways as evidenced by the authors, that is luxurious office complexes, excessive salary increases not commensurate with the performance of the corporations, company expenses for luxurious living and indemnity over liabilities (Shleifer and Vishny, 1997; Monks and Minow, 2004; Bebchuk and Fried, 2005; Das, 2006; Chalmers, Dann and Harford, 2006).

Corporate governance mechanisms could be basically divided into two as internal and external (Walsh and Seward, 1990; Jensen, 1993; Turnbull, 1997a; Hart, 1988; Eisenhardt, 1989). Internal corporate governance mechanisms comprise the BOD and the sub-committees of the BOD namely audit, compensation and nomination, compensation contracts for the managers, participation of owners in direct management, internal control systems and share ownership plans. The external corporate governance mechanisms comprise the statutory regulations such as the compliance for the provisions of the Companies Act, 2006 and non-statutory regulations such as the takeovers and mergers and the Codes on Corporate

Governance (FRC, 2006). The role of the NEDs in the BOD has been accepted across the world as the most significant in aligning the interests of the shareholders and the managers due to the role they could play in influencing the corporate decisions with outside objectivity. While the managers make decisions, the NEDs could ratify the decisions thus they become the professional referees (Fama and Jensen, 1983a).

Authors have discussed many facets of the NEDs which are essential to be effective in their role: Independence from management (IOD, 1995; Higgs, 2003; Brennan and McDermott, 2004), right attitudes to see the performance of the CEOs in the context of business cycles (Bettman and Weitz, 1983; Walsh and Seward, 1990), questioning the assumptions of the managers (Roberts, McNulty and Stiles, 2005) and the ability to understand the unitary board system (Conyon and Muldoon, 2006) are among them (Chapter 2). In the recent decade, the attention is brought about the cognitive aspects of the NEDs such as the need to develop the correct perception and attributions for the corporate success and the failure, scanning the future, sense making of the trends in the market, development of beliefs, expectations and considerations or assumptions on the corporate life cycle (Rindova, 1999; Forbes and Milliken, 1999: Haleblian and Rajagopalan, 2006).

Authors point out the role of the NEDs in four categories: advice, strategy, monitoring and service or the spanning the boundary of the firm (Stiles and Taylor, 2001; Pearce and Zahra, 1992; Johnson, Daily and Ellstrand, 1996). Roberts, McNulty and Stiles (2005) explain the need of making the executives accountable by probing and questioning the assumptions of them. Authors explain that the NEDs must engage in company matters and must be supportive while being NEDs. They should not assume

the role of an executive director. Combined Code (FRC, 2006) insists the above style of behaviour by the NEDs.

In the small and medium scale companies in the UK and other countries, in which the NEDs are employed, they play a much intensive role due to the demands of the companies as the firms are in the early stage of the life cycle or getting ready to 'go public' (Westhead, 1999; Deakins, O'Neill and Milliken, 2000; Berry and Perren, 2001; Corbetta and Salvato, 2004; Long, Dulewicz and Gay, 2005; Heuvel, Gils and Voordeckers, 2006; Minichilli and Hansen, 2007). Despite many of the aspects of how to make the NEDs effective and employment of the NEDs, corporate governance problems remain unresolved. Therefore, in the context of the emerging corporate governance problems over and over again, the contribution of the NEDs is a researchable problem, which exists as a gap of knowledge in the literature.

The gap of knowledge on the understanding of the role of NEDs appears in relation to the both developed capital markets and emerging markets (La Porta, De-Silanes and Shleifer, 1999; Vives, 2000; Goodwin and Seow, 2002; Monks and Minow, 2004). These authors point out the lack of knowledge about the sources of financing of the business firms and about the protection of interests of the shareholders if not the other stakeholders. Authors have documented various facets of corporate governance in these countries, namely, effectiveness of insider trading law in the stock exchanges (Bhattacharya and Daouk, 2002), effectiveness of law and order (La Porta *et al.*, 1998) and the nature of assistance of the regulatory bodies for new businesses (Klapper, Laeven and Rajan, 2006). However, the role of the NEDs is not getting attention of the authors adequately. Although there is a large number of statutory and

non-statutory codes of corporate governance (Figure 2.1 Chapter 2) and the contribution of authors to develop best corporate governance mechanisms (Chapter 2), agency problems (Fama and Jensen, 1983b) remain still unresolved. Therefore, there is an 'intellectual problem or a developmental puzzle' (Mason, 1996:15), that is the investigation of the role of the NEDs.

1.2 Goals, Aims and Objectives of Research

The goal of this thesis is to understand the role of the NEDs in the context of the implementation of the non-regulatory Codes on Corporate Governance. The aim is to design the research methodology only after making a review into the strengths and weaknesses of the existing research methodologies into the role of the NEDs. The objective is to execute the same with a view to identify a model on the role of NEDs useful for the corporate sector in Sri Lanka. These three aspects drive the research methodology, research context and the scope of research as explained below.

1.3 Research Methodology

Section 4.2 in chapter 4 has reviewed the strengths and weaknesses of the existing research methodologies before designing the research methodology. The main methodological issue identified is the lack of reliability and the validity of the methods in use which prevent replication of studies. Second, use of a limited range of research methodologies, among them mainly the testing of hypotheses to see the relationship of the number of NEDs and the performance of the firm. Even in the other research methods, such as the interviews with the NEDs, observations of the

boardroom and administration of questionnaires, there is a lack of explicit rules of categorising the tasks of the NEDs and labelling the roles identified.

Research methodology designed consists of two research methods namely content analysis and postal questionnaire survey. The principal method is the content analysis of selected sections of the annual reports of the AIM companies. Kassarjian (1977:8) explains content analysis is a research technique for the 'Objective, systematic and quantitative description of the manifest content of communication'. Content analysis explained in chapter 4 uses the Iterative Grounded Research methodology (Orton, 1997), that is the identification of the variables relevant for the role of NEDs from both the existing theoretical framework discussed in Chapter 2 and the identification of variables of significantly appearing in the annual reports. Berg (2004) argues that it is required to read the annual report comprehensively in order to identify the themes of interest and accordingly, all the sections of a sample of annual reports of AIM companies in the UK except the financial statements section and analysis were coded.

In order to ensure reliability and validity, several steps are discussed in the proposed research methodology (Chapter 4). Development of the coding instrument with decision rules on coding, examples of coding, data tabulation, statistical analysis with the most appropriate tool for nominal data (Chi Square test), labelling and discussion are discussed in Chapter 4. This task led to understand the true meaning of the content analysis as mentioned above by Kassarjian (1977). In addition to reading going backward and forward called 'constant comparison' (Denscombe, 2003:120) across the annual reports, trial and error method of data entry and the preparation of the structure of the data base itself demanded considerable time. With the passing of

coding of 50 annual reports in the first round of coding, we could understand the role of the NEDs within the unitary board system in the UK (Conyon and Muldoon, 2006). Coding of annual reports stopped when the second round of coding reached 75 annual reports. This is an informed decision in content analysis technique or what Glaser and Strauss (1967) and Ahuvia (2001) stated as theoretical sensitivity or completeness. However, in the discussion of the content analysis data (Chapter 6), we do not agree with the definition of Kassarjian (1977) which restrict the analysis only to the manifest variables (denotative meanings) but it is required to see the derivable meanings (connotative meanings) as pointed out by Ahuvia (2001) and Rauh and Stickel (1996).

Chi Square test analysis (Chapter 5) proves that there is randomness of the distribution of the content analysis data. Therefore, we could say that two of the properties of the coding process namely mutual exclusiveness and mutual exhaustiveness have been achieved. The level of rigour we have applied could not be seen among many papers which use the content analysis technique (Farrell and Cobbin, 1996; Perry and Bodkin, 2000; Jun and Cai, 2001, Harris and Attour, 2003; Beattie, McInnes and Fearnley 2004 a few to mention here). Some authors do not explicitly say that the content analysis technique was used for their papers but have introduced certain categories to explain the role of the NEDs (Deakins, O'Neill and Mileham, 2000; Roberts, McNulty and Stiles, 2005; Long, Dulewicz and Gay, 2005). Therefore, by developing the content analysis technique from coding to the type of discussion suggested for content analysis data, we contribute to the content analysis technique heavily.

For the postal questionnaire survey, the respondent was the CEO, a prime 'role sender' (Rogers and Molnar, 1976:598). NEDs must satisfy the aspirations of different stakeholders (Sarbins and Allen, 1968) who have a stake in the corporation and the CEO was identified as a major role sender (Chapter 4). Apart from that, what was expected is not only to understand the role of the NEDs from the perspectives of the CEOs but to get a first class understanding of ourselves on this method of data collection and to verify the argument of authors the difficulty of getting a statistically significant response (Pettigrew, 1992; Stiles, 2001; Stiles and Taylor, 2001; Starkey, 2002).

Postal questionnaire (appendix 1) was administered among the AIM companies based within Greater London. Some authors argue that the question of reliability should not be taken too seriously in qualitative concepts. Walliman (2005:211) argues that 'Logical justification is developed from arguments based on concepts and premises relating to the research problem'. Sutton and Staw (1995) also argue the adequacy of making logical arguments rather than statistical measures. In such contexts, they argue that there is no need to do a pilot testing of the questionnaire. Postal questionnaire designed is well backed up by the theory discussed in chapter 2 as such there was no need to do a pilot test. Further, in designing the postal questionnaire, the arguments of the authors for better response such as brevity, common sense constructs (Thayer, 1963), and putting only tick boxes was followed (Berg, 2004).

'Convenience sampling method' (Gray, 2004:88) was used for the selection of the respondent CEOs in companies due to the need to reach if the opportunity arises to interview with the least cost of travelling. Accordingly, 300 CEOs of AIM companies

were selected for the postal questionnaire. The response rate of 11.3 per cent is a mid value of two postal questionnaires of two previous research i.e. Stiles (2001) and Heuvel, Gils and Voordecken (2006), which have recorded a response rate of 13.4 per cent and 9.1 per cent respectively. It is difficult to make a probabilistic assumption of the response rate in time due to the difficulty of collecting a statistically significant number of papers which record the response rate (even if we forget about the time frame or the discipline).

Many authors who get data from postal surveys discuss their research results using the frequency analysis (Deakins, O'Neil and Mileham, 2000; Stiles, 2001; Berry and Perren, 2001; Heuvel, Gils and Voordecken, 2006). Papers which use content analysis also use frequency analysis exclusively (Farrell and Cobbin, 1996; Perry and Bodkin, 2000; Jun and Cai, 2001; Harris and Attour, 2003; Beattie, McInnes and Fearnley, 2004). To discuss the survey results, Chapter 5 uses the frequency analysis. However, had we obtained a response rate of 30 per cent from the CEOs, we could have done a unique population parameter value, that is the average number of CEOs who wish to have a particular role of the NEDs more than the other roles. This estimate could have been used in a subsequent replication of the same study to test a null hypothesis with an alternative hypothesis.

Although the response rate was not as expected, the CEOs have made useful comments. In addition to these, one CEO made a useful contribution by emailing his ideas on the role of the NEDs. His particular contribution was that the NEDs have a vital role as mentors. Mentoring role of the NEDs has a significant value for small and medium companies unlike in the large corporate sector where there is separation of

ownership and management which makes the monitoring role of the NEDs essential (Boussouara and Deakins, 2000). Thus, our scope of thinking and understanding (Mason, 1996 writes this as ontological components) gradually developed with the snowballing of the literature review throughout the thesis.

1.4 Context of Research

In order to execute the research methodology designed in Chapter 4, the choice of the research context (Johns, 2001) is guided by the following prerequisites, namely, the existence of PLCs, the emphasis on the need to appoint the NEDs into the BOD of the PLCs, the existence of non-regulatory Codes on Corporate Governance and the existence of a regulatory authority to check and balance the effectiveness of the implementation of the same. According to these prerequisites, the research context most suitable to execute the research methodology is in the UK where there is a culture of corporate governance (see figure 2.1 in chapter 2 to understand the historical development of codes on corporate governance) and the corporate sector which have a remarkable presence of NEDs.

Of the corporate sector in the UK, the most appropriate research context is the AIM as it has parallel characteristics for an emerging market economy such as Sri Lanka. They are: (1) the entry of entrepreneurial firms for listing; (2) the lack of explicit rules such as the minimum capital needs and submission of years of annual reports prior to listing and (3) the freedom to accept the non-regulatory codes on corporate governance but voluntary acceptance of the codes on corporate governance. AIM companies are required only to have a nominated advisor and a broker to liaise with

the London Stock Exchange (LSE) (AIM, 2007a). Although there are a number of entry requirements in Sri Lanka such as the minimum capital, number of years of published annual reports and tax declarations (SEC, 2006), some are in near comparison to AIM companies in terms of the sales volume, employment and equity capital, legal environment and the emphasis of the need to develop corporate governance with the appointment of the NEDs into the BOD.

1.5 Scope of Research

Chapter 3 shows that the corporate sector and the regulatory framework on corporate governance in Sri Lanka have been developed along with the introduction of the free economic policies. De-regulations such as the removal of regulations which prevented competition in many areas in the economy such as banking, insurance and industry and re-regulations such as the introduction of accounting and auditing standards and listing rules supported the economic policy (Samarakoon, 1999; ADB, 2005). Apart from these, empowering the regulatory bodies established years ago such as the Institute of Chartered Accountants in Sri Lanka (ICASL), the Security Exchange Commission (SEC) and the Central Bank of Sri Lanka (CBSL) and also enacting new laws to regulate the public utilities and amending the existing legal provisions took part. The acceptance of International Accounting and Auditing Standards and creation of self regulatory bodies such as the Insurance Ombudsman and the repeal of the company law of No. 17 of 1982 and replacing the same in 2007 (Company Act, No. 7 of 2007) show promising aspects in *good corporate governance* (Filatotchev, *et al.*, 2007). Given the above background, developing a research methodology and a model on the role of NEDs in the research context of AIM could be a useful contribution for

the corporate governance literature in general and for the emerging market economy in Sri Lanka.

The significance of the research carried out could be seen in methodological perspectives. When compared to the research studies based purely on the development of a theory and hypotheses and testing them with the archival data, the content analysis was a heavy task. However, this task was not only became enthusiastic but also knowledgeable as the content analysis knowledge now could be used to do future research in corporate governance research and also research in many other disciplines such as analysis of narratives in accounting reports, Management and Organisational Behaviour apart from teaching and training in documentary analysis.

The AIM market has been in operation since the mid 1990s with the growth of the number of companies seeking equity capital (AIM, 2007b). To our surprise, there are only two papers which have the words 'Alternative Investment Market' within the title (Mallin and Ow-Yong, 1998; Parsa and Kouhy, 2008). Mallin and Ow-Yong (1998) discuss the institutional framework of the AIM companies and Parsa and Kouhy (2008) discuss social reporting disclosures. There are very few studies in the UK in relation to small and medium sector companies too (see Westhead, 1999; Deakins, O'Neill and Milliken, 2000; Berry and Perren, 2001; Corbetta and Salvato, 2004; Long, Dulewicz and Gay, 2005). Therefore, this thesis contributes to understand a vital sector in the AIM companies.

1.6 Major findings

The salient features of the survey findings (chapter 5) discussed in the chapter 6 are as follows: (1) directors have a multiple work environment and support the earlier findings in both large and small corporations (Westhad, 1999; Deakins, O'Neill and Mileham, 2000; Stiles, 2001; O'Higgins, 2002), (2) there is a difficulty of separating the contribution of the NEDs from the other directors in the unitary board system in the UK (Conyon and Muldoon, 2006), (3) difficulty of categorising the role of NEDs into four categories namely strategy, advice, service and monitoring (Stiles and Taylor, 2001). Survey finds that the NEDs create positive beliefs and expectations among the management and the shareholders on the well being of the corporation. Thus they perform several cognitive tasks too.

Survey results find a multiple work environment of the NEDs in the AIM companies similar to the contribution of NEDs in the small and medium sector companies in the UK. Many reasons could be listed for this: The AIM companies are growth oriented and they are aimed at developing the corporate governance in order to be listed in the main board of the LSE (AIM, 2007a). Diversification of business through acquisition of firms is a major reason for the listing of AIM companies according to the analysis of annual reports (Annual reports coded for content analysis). After the acquisition, they need the expansion of the BOD with the NEDs. The NEDs have to assist the initial board members to carry out a range of tasks not only what they already do such as planning strategy, execution and visiting a foreign country to deal with the market entry but in many corporate governance activities such as designing of the service contracts for the managers and the development of the board procedures. Unlike in the

FTSE companies, the NEDs in majority of the AIM companies do not have a term of reference for their tasks and the survey results portray the boardrooms of AIM similar to a bee hive.

Because of the above nature of findings, we are able to proceed with the initial stages of identifying the variables for a model on the role of NEDs in Sri Lanka. However, as earlier pointed out that such a model development needs empirical research. Therefore, we could be content with the findings required for a model development in the future. The survey results indicate the necessity of doing further research in several areas, among them the understanding of the role through the perspectives of many role senders other than the shareholders and the CEOs and understanding the cognitive tasks of the NEDs.

1.7 Limitations

Any research method has its own strengths and weaknesses (Walliman, 2005). Despite several attempts to increase the response rate for the postal survey such as sending a memo and speaking to the companies over the phone, the response rate was not adequate enough to do a parametric test (Cooper and Schindler, 2003). Thus the response rate limited the desire to understand how the control variables such as the age, experience, educational background, the nature of CEO relationship to the firm and tenure of the CEO (see questionnaire in appendix) influence the contribution expected of NEDs, attitudes and expectations. Second, an inherent difficulty is the understanding whether the CEOs themselves have responded for the postal survey. Therefore, it is unable to make a probabilistic assumption whether there is sincerity in

replying the answers. However, there are some useful comments in completed questionnaires. There is another difficulty of verifying the true nature of the annual report disclosures. These problems in relation to questionnaires and documentary evidence have been well documented by authors (Atkinson and Coffey, 2004; Abeysekera, 2006).

Content analysis also could have improved if we had few more coders to develop the coding instrument at the initial stage and at the stage of the proper coding. However, Ahuvia (2001) and Milne and Adler (1999) mention that in lieu of the multiple coders, the single coder could prove his knowledge by the literature review and the coding instrument. We believe that the literature review (Chapter 2), coding instrument (table 4.1), and many steps in the content analysis (Chapter 4) are strong enough to ensure that the content analysis meets the criteria of good research (Bacharach, 1989; Sutton and Staw, 1995).

1.8 Structure of the Thesis

The thesis is divided into seven chapters. This chapter is an introduction of the thesis. Chapter 2 discusses the general theoretical framework in corporate governance. It is aimed to achieve two objectives namely to facilitate to understand the corporate governance framework in Sri Lanka and to develop the research instruments for the survey for this thesis. In order to make this task easy, literature review is done on several facets on corporate governance. Among the discussed areas are the background to the enhanced interest in corporate governance, major theories, the role of the codes on corporate governance, the experience of the implementation of them

and the reasons for the rapid acceptance of them by the corporate world. This chapter points out that despite the regulatory and non-regulatory developments in corporate governance, agency costs still remain unresolved and identifies the role of the NEDs as a researchable problem or a 'development puzzle' (Mason, 1996:15).

Chapter 3 focuses to understand the existing corporate governance framework in Sri Lanka. It identifies a heavy regulatory environment in the country. The data tabulated to indentify the nature of corporate sector suggests that the regulatory framework has developed simultaneously with the rapid development of the corporate sector since the introduction of the open economic policies in 1977 after few decades of economic policies which did not encourage the development of the capital market. This chapter argues that the corporate sector has now matured enough to introduce non-regulatory codes on corporate governance. Discussion points out several challenges in the implementation of a code on corporate governance due to number of bottlenecks arising out of the characteristics of the social, economic and political environment. However, this Chapter identifies a promising environment for *good corporate governance* (Filatotchev, *et al*., 2007) as evidenced by appreciation of the contribution of some regulatory agencies such as the Registrar of Companies (Batra, 2006) and in the areas of disclosure levels in the country (Bushman, Piotroski and Smith, 2003).

Chapter 4 discusses the research methodology. We identified that the existing methods of research into the role of NEDs is heavily biased on testing of hypotheses with the archival databases. Such methods do not reveal what exactly the NEDs do in the corporations as well as how they contribute. Therefore, the research methodology was designed to ensure reliability and validity with replication of the methodology in

the same research context later or in another research context and the triangulation of research methodology, that is number of theoretical perspectives as well as number of research methods (Tashakkori and Teddlie, 1998).

Chapter 5 analyses the survey results. The calculated Chi Square value of 16.85 with 26 degrees of freedom and 5 per cent degree of confidence is less than the table value of 38.85 (Chi Square statistical table appendix 2). The null hypothesis established for the Chi Square test was that the observed values and the expected values are equal. Expected values reflect the theoretical distribution or the probabilistic distribution of the categories (For example, if a fair coin is tossed, the probability of getting either the head or tail is 0.5). The Chi Square test statistics proves the randomness of the distribution of the coded data, and therefore the protection of the two properties explained in the content analysis, that is mutual exclusiveness and mutual exhaustiveness of the categories. The survey data uncovered the cognitive tasks of the NEDs namely, beliefs, expectations and considerations or assumptions. Many authors emphasise the need to undertake empirical investigation of these cognitive tasks (Rindova, 1999; Forbes and Milliken, 1999; Haleblain and Rajagopalan, 2006).

Chapter 6 discusses the survey results comparing and contrasting with the previous results. Content analysis finds that the NEDs perform a multiple number of tasks. Among them are the cognitive tasks such as beliefs, expectations, considerations and assumptions. This chapter points out the difficulty of putting these multiple tasks neatly into the categories explained in the papers (Stiles and Taylor, 2001), namely strategy, advice, monitoring and service or as conformance and performance roles. Further, the thesis argues that the roles are not identifiable as straight forward roles of

the NEDs but originating from the NEDs through the interplay of the cognitive orientations of them. Further, the thesis argues that the roles are conditioned by the expectations of the CEOs. This discussion is based on logical arguments (Reynolds, 1971; Toulmin, Rieke and Janik, 1979), based on many theories in organisational behaviour, psychology and sociological theory related to discuss the behaviour of the CEOs and NEDs in corporate governance (mainly section 2.8 in chapter 2). In order to support this argument, researcher uses the postal survey results too as it has the views of the CEOs, one of the roles senders discussed in role theory (Sarbin and Allen, 1968). Many authors use the postal survey data as a secondary source and mainly to support the discussion of the data gathered through the principal method (Stiles, 2001: Heuvel, Gils and Voordeckers, 2006).

Chapter 7 concludes the thesis. It consists of several sections namely the summary of the thesis, contributions made to carry forward the debate on the role of the NEDs, limitations of research for this thesis and future research intended to carry out with the knowledge gained in this thesis. Thesis concludes that there is a need to undertake continuous research on the role of NEDs and also through many stake holders' perspectives in order to develop a general theory on the role of NEDs.

1.9 Conclusion

This chapter could be considered as a quick reference to the thesis due to the discussion of the contents of the thesis namely the research problem solved by the thesis, context of research, goals and objectives of research, scope of research, research methodology, findings and thesis structure. Thus, this chapter is the road

map to the thesis. Next chapter begins the discussion on the general theoretical framework on corporate governance.

Chapter II

Theoretical Framework

2.1 Introduction

The aim of this chapter is to outline the general theoretical framework on corporate governance. Two objectives are aimed to achieve with the above. They are: (1) to analyse the corporate governance framework in Sri Lanka (Chapter 3), and (2) to design the research instruments backed by the theory to ensure reliability and validity (Chapter 4) (Bacharach, 1989; Whetten, 1989; Weick, 1989; Dimaggio, 1995; Sutton and Staw, 1995; Weick, 1995; Walliman, 2005; Chermack, 2007). In order to reach the aim and objectives mentioned above and to make the theoretical framework easy to comprehend, this chapter discusses aspects of corporate governance divided into many sections.

2.2 Nature and Magnitude of Corporate Governance Problems

Corporate frauds (Treadway Commission, 1987; US Senate, 1992; Tonge, Greer and Lawton, 2003, Financial Crimes Report to the Public, 2006)[1], excessive salary increases of the Chief Executive Officers (CEOs) and other executive directors disproportionate to the performance of the firm (Boyd, 1994; Roundtable Conference, 2004; Bebchuk and Fried, 2005; Bebchuk and Grinstein, 2005) and loss of public trust of many public limited liability companies (PLCs) (Commission on Public Trust and Private Enterprise, 2003; Rayman-Bacchus, 2006), etc. raise the question of efficiency

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[1] See the following web sites to see some of the corporate frauds in the UK and press releases:

Corporate frauds: http://www.insolvency.gov.uk/cib/inspectorsreports.htm

Press releases: http://www.insolvency.gov.uk/cib/press.htm

and effectiveness[2] of the BOD especially the NEDs in the discharge of their fiduciary responsibilities (French, 2003; Jensen and Fuller, 2002). Many authors raise a direct question as to the effectiveness of the contribution of the NEDs (Kesner and Johnson, 1990; Byrd and Hickman, 1992; Jensen, 1993; Useem, 2003; Dulewicz and Herbert, 2004; Belden, Fister and Knapp, 2005; Miwa and Ramseyer, 2005; Helland and Sykuta, 2005; Fich and Shivdasani, 2006).

Authors document increased concern by some key stakeholders on the role of NEDs namely, shareholders (Koehn and Ueng, 2005; Jong, Mertens and Roosenboom, 2006), employees (Clapham and Cooper, 2005), and debtors (Day and Taylor, 1998). However some authors point out inadequate participation of institutional investors in corporate governance (Agrawal and Mandelker, 1992; Clyde, 1997; Luoma and Goodstein, 1999; Pozen, 2003; Aguilera, 2005; Aguilera *et al.*, 2006). Negligible attendance of the shareholders both small and large including the institutional shareholders at the annual general meetings is also found by many authors (Warren, 2002; Stratling, 2003; Hodges, Macniven and Mellett, 2004). Birds *et al.*, (2000) report that even for critical meetings such as the discussion of an emerging bankrupt threat for the company, the shareholders are not keen to attend the meetings.

The inadequate attention by the shareholders both institutional and the dispersed shareholders among the stakeholders mainly leave the managers to opportunistic behaviour (Berle and Means, 1933; Jensen and Meckling, 1976; Willimason, 1993; Chalmers, Dann and Harford; 2002; Das, 2006; Luo, 2006) which lead to

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[2] Efficiency is obtained when output is increased with the lowest cost of inputs (doing the things right) and effectiveness is obtained when doing the right things at the right time by the right person (Drucker, 1974 and 1994).

expropriation of assets of shareholders through perquisites, thefts and channelling of business to the firms owned by the managers and their relatives (Berle and Means, 1933; Shleifer and Vishny, 1997). A conducive environment for such managerial behaviour arises in many countries, both developed and developing, due to the lack of effectiveness of law and insider trading laws (La Porta *et al*., 1998; Bhattacharya and Daouk, 2002), and bureaucratic barriers to entry by new firms (Klapper, Laeven and Rajan, 2006). All of these prevent competition emerging as competitive markets could prevent the large shareholders as well as the corrupt officials getting private benefits.

Opportunistic managers could cripple corporate governance mechanisms i.e. internal control systems and market control in many ways (Kosnik, 1987; Walsh and Seward, 1990; Westphal, 1998). Interlock directorships could be used to form opinions against the emergence of regulations, which the interlocked directors think as disturbing or intervening in business activities (Ornstein, 1984; Kosnik, 1987; Davis, 1991; Davis and Greve, 1997; Haunschild and Beckman, 1998). Information asymmetry between the management and the NEDs (Brennan and McDermott, 2004; Reggy and Manen, 2004) help managers to hide their inefficiency and ineffectiveness when they thwart corporate governance mechanisms (Belkaoui and Karpik, 1989; Deegan, Rankin and Tobin, 2002; Hope, 2003; Bushman, Piotroski and Smith, 2004).

In order to ensure accountability and transparency in corporate business operations, some authors argue the need to have more corporate market activity especially the hostile takeovers (Jensen, 1993; Cuervo, 2002; Stenberg, 1997; 2004) and the need to improve competition in the product markets (Mayer, 1997; Randoy and Jensen, 2004). Leuz, Nanda and Wysocki (2003:506) argue that 'Strong and well enforced outsider

rights limit insiders' acquisition of private control benefits and consequently, mitigate insiders' acquisition of private control benefits, and consequently mitigate incentives to manage accounting earnings because they have little to conceal from outsiders'. They point out that market forces are effective in disciplining the managers.

Among the corporate governance mechanisms, the BOD is considered as the most important among many others such as investor activism, market control and regulations (Jensen, 1993; Filatotchev, *et al.*, 2007). Many papers have addressed various ways of constituting an efficient and effective BOD: Separation of power between the chair and the CEO (Rechner and Dalton, 1991; Fama and Jensen, 1983a; Finkelstein and D'Aveni, 1994), composition of the BOD (Hermalin and Weisbach, 1988; Kesner and Johnson, 1990; Barnhart, Marr and Rosentein, 1994; Bathala and Rao, 1995; Beasley, 1996; Dan *et al.*, 1998; Hillman and Dalziel, 2003; Pye and Pettigrew, 2005), the need to distinguish the role of the NEDs while advising the executive directors on strategy and monitoring the same executive directors sitting together (Ezzamel and Watson, 2000) are among some of the organisational aspects discussed.

The process within the BOD such as the norms and manners (Mace, 1971), conduct of meetings, areas to be focused etc. is addressed by many authors (Pettigrew and McNulty, 1995; Taylor, 2004). The need to be decisive in monitoring the executive directors by the NEDs especially removal of inefficient CEOs (Jensen and Fuller, 2002), the need to make more attention for the strategic function (McNulty and Pettigrew, 1999; Forbes and Milliken, 1999; Stiles and Taylor, 2001; Pye, 2002a; Hendry and Kiel, 2004; Thomas, 2005; Ruigrok, Peck and Keller, 2006), the need to

improve the facilities and information for the NEDs (O'Higgins, 2002; Higgs, 2003; Pass, 2004; Roberts, McNulty and Stiles, 2005), the need to develop methods of evaluation of the BOD (Dan *et al.*, 1998; Dalton, Johnson and Ellstrand, 1999; Duelwicz and Herbert, 2004; Berge and Levrau, 2004; Collier, 2004), the need to look at the internal governance arrangements to motivate and get corporation of the internal employees (Child and Rodrigues, 2004), the need to understand the cost and benefits of board committees (Spira, 1999; Gendron and Bedard, 2006; Spira and Bender, 2004; Vafeas, 1999: Menon and Williams, 1994; Conyon and Peck, 1988), the importance of the NEDs as a disciplinary force (Mace, 1971; Dahya, McConnell and Travlos, 2002) are among many papers which look at redesigning the BOD in many ways to be efficient and effective in corporate governance.

2.3 The Significance of PLCs as Social Units

Authors have a consensus that PLCs are social units which have constant interactions being influenced by the societal forces and also influencing the societal forces (Warren, 1966: Warren, 1969; Feldman, 1981; Singh, Tucker and House, 1986; Soeters, 1986; Starr and Macmillan, 1990; Jensen, 1993; Drucker, 1994; Menon and Williams, 1994; Morgan, 1997; Pagano, Panetta and Zingales, 1998; Mullins, 1999; Pennington, 2000; Bowels and Gintis, 2002; Dent and Whitehead, 2002; Monks and Minow, 2004; Hong, Kubik and Stein, 2004; White, 2004; Romal and Hibschweiler, 2004; Welch *et al.,* 2005; Šević, 2005).

Corporate governance in PLCs is important in many aspects. Creation of employment opportunities, continuity in production of goods and services required by the

customers and contribution for the economy of a country (Jensen, 1993; Turnbull, 1997a) and the global operations[3] of PLCs, especially the role played in the world capital markets are among them (McKinsey Global Institute, 2005). The amount of debt securities of the corporate sector as reported by McKinsey Global Institute (2005) in their report on *'$ 118 Trillion and Counting: Taking Stock of the World's Capital Markets'* has contributed 44 per cent of global financial stock growth since 1993 with increased financial deepening measured by *depth*[4] and with reduced dependence on traditional bank financing. Krishnamurti, Šević, and Šević (2005) find that there are a growing number of corporations in the emerging markets, which seek equity capital in the New York Stock Exchange.

Failure of corporate governance in PLCs results in a huge social cost to be borne by the society especially by the taxpayers as evidenced by the historical case of the South Sea Bubble (Chapman, 1986) and with more recent cases such as the Enron, World Com etc. to name just a few (Jensen, 1993; Šević, 2005)[5]. Among the anti-social practices of the PLCs, unethical behaviour such as bribing the politicians[6] in competing for business opportunities (Goodpaster, 1991) and socially desirable reporting other than reporting the true nature of the consequences of business

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[3] Theory and the practice of corporate governance in multinational enterprises are discussed by Luo (2005a; 2005b). The author builds the theoretical framework upon the general theoretical framework of corporate governance and adds the dimension of international environment into the context.

[4] *Depth* is explained as 'The ratio of the global financial stock to the size of the underlying global economy measured by world gross domestic product' (McKinsey Global Institute, 2005:12).

[5] In 2007, The Northern Rock Bank in the UK borrowed from the Bank of England in order to avert a possible collapse due to the loss of confidence from the public especially the depositors. See: http://news.bbc.co.uk/1/hi/business/6997765.stm

[6] BCCI bribed politicians and officials of 73 countries to secure Central Bank deposits: See BCCI Affair Executive Summary: http://www.fas.org/irp/congress/1992_rpt/bcci/01exec.htm

operations (Campbell, Craven and Srives, 2003), demand public participation in corporate governance (Jones and Goldberg, 1982) and establishment of sound social and business legitimacy in corporate decisions (Neilsen and Rao, 1987; Ashforth and Gibbs, 1990; Laroche, 1995; Suchman, 1995; Deegan, Rankin and Tobin, 2002; Warren, 2003; Hill, Stephens and Smith, 2003; Power, 2003; Rayman-Bacchus, 2006).

PLCs are keen to establish social legitimacy but many authors raise authenticity of the practice. Belkaoui and Karpik (1989:38) argue that 'Image building and public interest concerns may govern the decision to spend for social performance and to disclose social information'. Ashforth and Gibbs (1990:181) write that 'Membership on the BOD by prominent citizens … formation of board committees is to provide appearance'. Establishment of the audit committee is also a way of showing legal, moral and social legitimacy (Power, 2003). Campbell, Craven and Shrives (2003) point out that it is a big challenge for a PLC to perceive the needs of various segments of the society to establish acceptable social legitimacy. Weaver, Trevino and Cochran (1999) find that 'Executives sometimes may take a particular stance toward ethics programs because doing so is presumed to enhance or maintain organizational legitimacy and thus contribute to financial performance by securing the support of key institutional actors' (1999:540). Lewis (2006:51) points out that 'Managers perceive corporate social responsibility as a method to manage two sets of risks. The regulatory risk as self-regulations consist a potential alternative to public regulation. Second social risk as corporate codes of conduct attempt to answer civil society's demand for more responsible businesses'.

Obst and White (2005) point out despite any type of attempts to show legitimacy, society makes the judgment and social identification of the firm. Therefore, desired social legitimacy is not socially desirable reporting because such attempts 'Create spurious (i.e. misleading) correlations between variables; (b) suppress (i.e. hide) relationships between variables; and moderate (i.e. interact with relationships between other variables' (Zerbe and Paulhus, 1987:251). Singh, Tucker and House (1986) measure organisational legitimacy by the size of contribution for the charitable organisations, listing in a particular social directory and measuring the size of the BOD of a PLC. Mizruchi (2004) points out the need to understand the influence of the PLCs on the society. This author argues that the sociologists have hailed the broad based ownership of the US companies (Belre and Means, 1933) as a welcome sign of a plural society few decades ago, but they are now not doing adequate research to see the implications of the PLC on the society. Piesse (2005) also holds the same view of the above author.

2.4 Solutions for the Corporate Governance Problems

The solution for the corporate governance problems of the largest capital markets, that is the US and UK (McKinsey Global Institute, 2005) which had the highest number of large-scale corporate collapses in the previous decade, implemented measures to address the corporate governance crisis in two different ways. In the UK, the introduction of non-regulatory corporate governance codes such as the Code of Best Practices (Cadbury, 1992), Recommendations on remuneration for executive directors (Greenbury, 1995), guidelines for the directors on audit committees (Smith, 2003) and recommendations on the role and effectiveness of NEDs (Higgs, 2003) enhanced the

debate on corporate governance. Financial Reporting Council incorporated many of the recommendations of these reports into the Combined Code on Corporate Governance (FRC, 2003 and 2006). The Combined Code (FRC, 2003) is in implementation through the listing rules in the London Stock Exchange (Global Finance Online, 2005) whereas in the US, the Security Exchange Commission made PLCs compulsory to adhere to the legislation of *Sarbanes-Oxley Act of 2002*.

Main recommendations of the Combined Code on Corporate Governance (2006), that is the establishment of sub-committees of the BOD namely nomination, audit and compensation, which comprise the majority of NEDs, must take the decisions such as the remuneration of the CEO and the appointment of the auditors and decisions on audit fees. It is a big change within two decades of the Cadbury (1992) although it has suggested these recommendations though the UK government has not considered the implementation seriously (Jones and Pollitt, 2003).

2.5 Criticisms for the Above Solutions

Confederation of British Industry (CBI) has done a survey (CBI, 2006a) of FTSE 100 chairs[7] to understand the response of the corporate sector in the UK for the suggestions of the Higgs review (Higgs, 2003). It has found that of the respondents, 82 per cent of chairs do not agree with the recommendation of appointing a senior independent director, as they believe that their task would be undermined if this position is created. Director General of the CBI comments that 'Primary board

[7] The word chair is used without considering the gender basis in this survey. However, there are a few women directors in UK boardrooms (Singh and Vinnicombe, 2004; Mori, 2003).

responsibility for communication with shareholders must rest with the chairman' (CBI, 2006a). The suggestion of the Higgs review for the appointment of the nomination committee also has been strongly opposed by 83 per cent of the chair (CBI, 2006a). Increase of cost for the business firms to recruit and pay the compensation to NEDs (Vafeas, 1999), lack of training for the NEDs, questioning the rational of the recommendations of the Higgs review in the absence of any comparable corporate collapses in the UK compared to the US are other criticisms levelled at the Higgs review (CBI, 2006b).

Several authors are sceptical of the success of the Higgs recommendations (Higgs, 2003) which were incorporated to the Combined Code (FRC, 2003). Jones and Politt (2003) raise the acceptability of the above Code by the corporate sector in the UK when it was compared with the Cadbury (1992). They point out that Cadbury (1992) was a contribution from the professionals in many fields such as management and accounting whereas the Higgs review was prepared by a single person with the assistance of several civil servants. Therefore, they question the legitimacy of the Higgs review. Kirkbride and Letza (2004) take the extreme end of pessimism of the non-regulatory codes on corporate governance. 'What extent can society relies on self regulation as the sole means to ensure good corporate governance, or would corporate entities be better governed through other means, for example, through statute?' (2004: 85). Augmenting these views, Combined Code on Corporate Governance (2003) itself (also the 2006 Code) keeps the responsibility of the shareholders to be knowledgeable of the declarations of a PLC because this Code is based on the principle of comply or explain basis. 'It is for the shareholders and others to evaluate the company's statement' (FRC, 2003:1 and FRC, 2006:1).

2.6 Acceptance of Corporate Governance Recommendations

In the preface to the book of Stiles and Taylor (2001: i), the impact of the Cadbury (1992) report is stated as follows. '…they started a train of events that changed the face of British boards and led to a worldwide movement for the reform of corporate governance'. Many countries attempt to design codes on corporate governance modelled on the principles of the Cadbury (1992) (Vienot report, 1999; Tam, 2000; Mertzanis, 2001; Cromme, 2005). Cromme (2005) points out that the preparation of the corporate governance code in Germany has been influenced by the 'Different codes of Great Britain' (Cromme, 2005:363). As Jeffers (2005) sees these developments convince institutional investors both the UK and the US to invest in several countries in Europe and postulate convergence of corporate governance models, i.e. shareholder model and the stakeholder model. However, Schmidt and Tyrell (1997) point out that even in the capital market countries, bank financing of firms is a regular feature for further needs of capital.

Despite the criticisms of the Higgs review recommendations, PLCs in the UK (chapter 5) have accepted the principles and provisions of the Combined Code (FRC, 2003) and prove what Stiles and Taylor (2001) identified as a wave of acceptance of the codes on corporate governance. Some PLCs comply with some of the recommendations of the Combined Code on Corporate Governance (2003) while others comply with it fully. Acceptance of this Code by the corporate sector has a precedent, i.e. Cadbury (1992): The appointment of the NEDs, formation of sub committees of the NEDs (remuneration, nomination and audit) and separation of the powers of the chair and the CEO, etc. (Ezzamel and Watson, 2000; Dahya,

McConnell and Travlos, 2002; Pass, 2004; Spira and Bender, 2004; Page and Spira, 2005). In Germany, Cromme (2005) finds that the corporate governance code implemented in 2002 was accepted by 93 per cent of firms in 2003. The need to attract foreign investors and the influence of the institutional investors to make corporate governance more transparent and accountable are the most visible reasons for such high response (Turnbull, 1997a).

2.7 Persistent Corporate Governance Problems

The prime objective of the codes on corporate governance is to ensure transparency and accountability of the corporate managers to ensure accountability to the shareholders and effective operation of the free market (FRC, 2006). However, it is questionable whether the intended objectives are met at least in the short run. Examples are immense: Luo (2006:122) explains a variety ways of exercising opportunism.[8] 'In cooperative relationships such as joint ventures and cooperative arrangements as the acts or behaviour performed by one party to seek unilateral gains at the expense of another party or parties by breaching explicit or implicit agreements, exercising private control, withholding or distorting information, withdrawing commitments or promises, shirking obligations, or grafting joint earnings' (Luo,

[8] Extensive explanation of the concept of opportunism and application across several disciplines is explained by Niewerth and Korting (2002). They point out that there is no common definition for the word 'opportunism'. 'In the social context it stands somewhere between egoism and altruism' Niewerth, and Korting (2002:253). Accordingly, opportunistic behaviour in the context of corporate governance is to be understood as tilting more towards the egoism. However, Hendry (2005) points out managers behave altruistically also. Stiles and Taylor (2001) point out the difficulty of getting appointments from top management. Therefore, interviewing top management personnel known to researchers is also opportunism. Starkey (2002) reports how a leading author speaks of getting samples of directors for interviews.

2006:122). Chalmers, Dann and Harford (2002) find that managers buy insurance policies against job risks in IPOs. Das (2006) argues that formation of partnership companies is created to get private benefits.

Among many others, deliberate actions of some governments to prevent entry of new firms into the market either as producers or intermediaries both in the developed and developing countries prevent competition and protect the interests of the corrupt officials and business firms (Klapper, Laeven and Rajan, 2006; La Porta, De-Silanes and Shleifer, 2002). Financial accounting frauds (Davidson, Stewart-Goodwin and Kent, 2005; Leuz, Nanda and Wysocki, 2003), covering of corporate frauds and accounting errors through organisational wide deception (Fleming and Zyglidopoulos, 2006), excessive salary increases which are not in commensurate increase of the performance of the firms (Bebchuk and Fried, 2005; Bebchuk and Grinstein, 2005), removal of the chair and the CEO simultaneously from their positions by the shareholders (Florou, 2005) indicate the magnitude of opportunism.

There is a constant debate about a plea for less codes (Cuervo, 2002; Stenberg, 1997) and about '… nature and desirability of self-regulation within a statutory framework' (Demirag, Sudarsanam and Wright, 2000:345) and the ability of the codes to correct corporate governance problems (Kirkbride and Letza, 2004). However, there is an argument to ensure and build public confidence on the corporate sector, as it is an efficient and effective source of low cost capital mobilisation (Commission on Public Trust and Private Enterprise, 2003). Therefore, the above commission writes that '... sustaining confidence and trust in the performance of that corporate system is a matter of public concern' (2003:15).

Persistent corporate governance problems explained above and the acceptance of codes on corporate governance is a paradoxical development or a 'paradoxical compliance' (MacDonald, Nail and Levy, 2004:81). Therefore, reasons for emerging such a situation and how they are occurred have to be investigated. As questions, they are very simple but finding of answers are not as simple as evident with the discussion later in this thesis. However, the emphasis of the Financial Reporting Council in the UK is to bring more non-regulatory codes on corporate governance (FRC, 2006) whereas in the US, more statutory regulations as shown by the *Sarbanes-Oxley Act, 2002*. When we look at the number of non-regulatory codes on corporate governance introduced since Cadbury (1992) to date (see figure 2.1 below), it may be possible to see more codes on corporate governance. Larsen and Smith (2007) argue that there is a possibility of introducing a Code on Equity Funds[9] in the UK by the government.

The traditional view of the firm as a mechanism with fixed parts which has fixed set of interactions and a certain set of predictable outcome (Gharajedaghi and Ackoff, 1984) and the firm as a set of legal contracts (Jensen and Meckling, 1976) is unable to answer the persistent corporate governance problems mentioned above. Jensen (1983) points out the need to look at the firm through a new perspective in explaining the limitations of understanding the firm purely as an economic model based on contractual relations alone.

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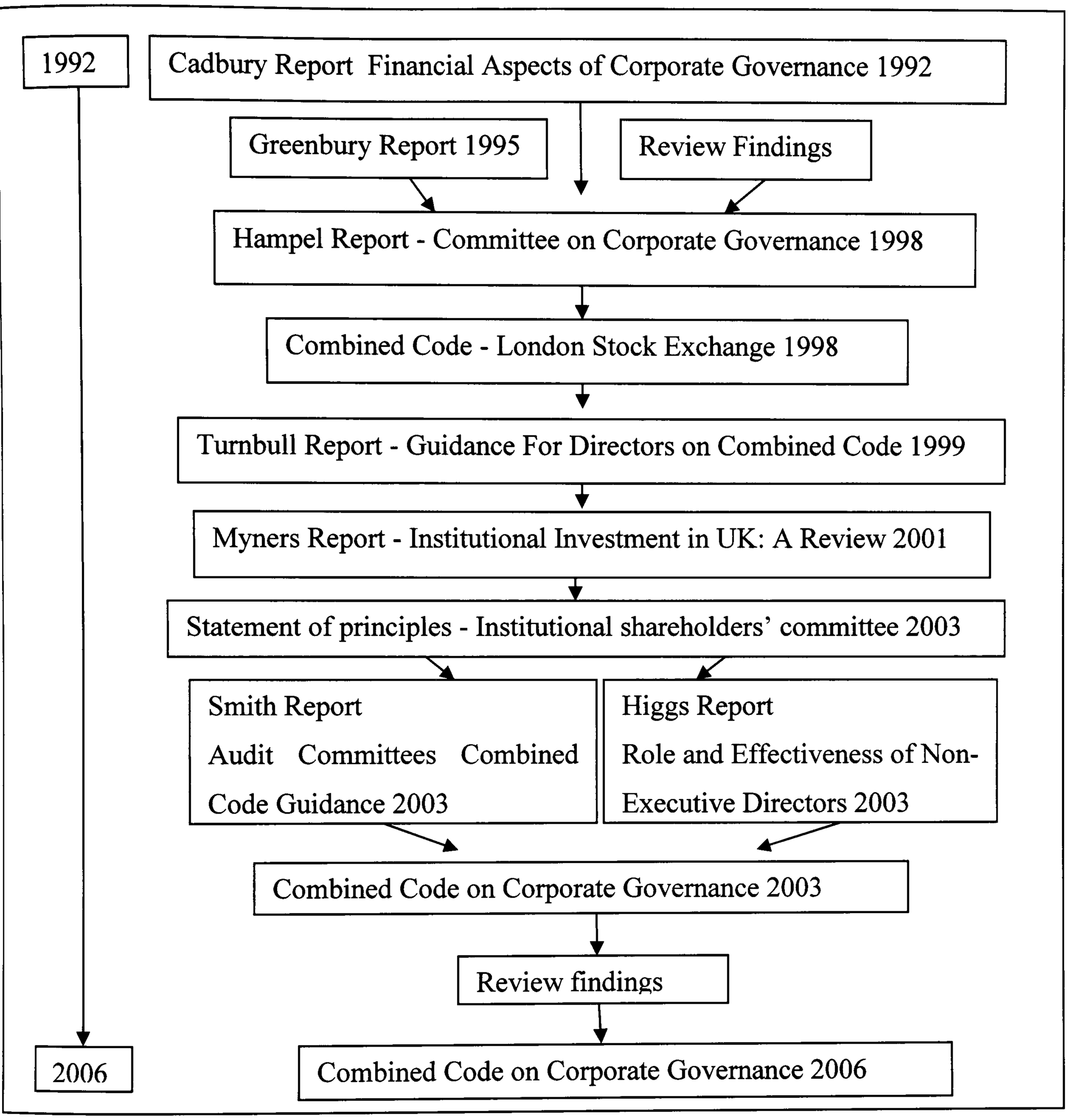
[9] See the following web site to see the names of private equities.
http://www.altassets.net/fundlinks/fl_uk.php

Figure 2.1

Development of codes on corporate governance in the UK



Source: Taylor (2004:418) (Arrows do not show straight away that there is a hierarchy but only the yearly development leading to the Combined Code, 2006).

Mangos and Lewis (1995:38) argue that 'When a paradigm is limited to its empirical and ethical scope and is used to formulate theories and policies the study of our world suffers'. Therefore, leaving the structural view and the contractual view of the firm

aside, there is a need to look at the firm through a new perspective (Hira and Hira, 2000).

2.8 Defining Corporate Governance

The overall aim of the non-regulatory codes on corporate governance shown in figure 2.1 and statutory regulations such as the Companies Act, 2006 and Sarbanes-Oxley Act 2002 is to provide an institutional framework to win the confidence of the share markets to attract and retain equity capital from individual investors and from institutional investors or 'patient low cost capital' (Monks and Minow 2004:530). 'Patient capital' (Aguilera *et al.,* 2006:150), i.e. pension and insurance funds amongst the institutional capital are significant sources of financing for a corporation because the institutional funds do not wish to exit unlike the minority shareholders as such actions damage their own interests in the corporations where they have investments. Significance of long term and structured development of the capital markets has been understood in the UK since the 17th century (Chapman, 1986). The Act of 1,697[10] was aimed 'To restrain the number and ill-practice of brokers and stock jobbers' (Chapman, 1986:27) who were the unofficial advisors to the investors. The adverse effects of a lack of an institutional framework is explained by Chapman (1986) vividly in the face of the South Sea Bubble '… it was not until the next century that a large crop of joint stock companies were formed, a development brought about by an acute shortage of capital both at home and abroad' (Chapman, 1986:31-32).

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[10] See web site. http://www.british-history.ac.uk/report.aspx?compid=46880&strquery=act 1697 brokers and stock jobbers

Cadbury (1992) explains corporate governance as 'The system by which companies are directed and controlled' (Cadbury, 1992:15)[11]. This definition does not give any clue to understand what the structural system is but Cadbury (1992) explains the need to strengthen the financial controls of the corporation and the appointment of number of sub committees in the BOD headed by the NEDs. Mizruchi and Stearns (1988) and also Clarke (2004) point out that the business cycles demand a change of the prevailing corporate governance systems to face the emerging economic and social environment. Filatotchev (2005) points out that there is a need to look at the suitability of a particular corporate governance mechanism at various stages of the life cycle of a firm namely, growth, maturity, decline and turn around stages.

Shleifer and Vishny (1997) write that 'Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment' (Shleifer and Vishny, 1997:737). Another strong advocate of the principal agent theory (Jensen and Meckling, 1976) as well as a critic of the stakeholder theory (Freeman and Reed, 1983), Sternberg (2004) identifies corporate governance as '…ways of ensuring that corporate actions, agents and assets are directed at achieving the corporate objectives established by the corporations' shareholders' (Sternberg, 2004:27). Stenberg (1997) argues that it is difficult to uphold fiduciary responsibilities of the BOD when there are a large number of unspecified and still evolving number of stakeholders than the originally introduced

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[11] 'A system can be defined as a network of interrelated procedures that are joined together to perform an activity or to accomplish a specific objective. It is in effect all the ingredients that make up the whole' (FitzGerald and FitzGerald, 1987:5). Mingers (2004:404) writes 'A system consists of components of different types, the relations and interactions between those components (the system's structure), the relations and interactions between those components (the system's structure), and some form of boundary that demarcates it from its environment)

by Freeman and Reed (1983). In both of these definitions, the achievement of the objectives of the shareholders is considered as the ultimate aim of corporate governance. Hendry (2005) questions this implied assumption of shareholders as having only the motivation for profits and argue that there can be altruists among shareholders.

The emphasis to achieve only the objectives of the shareholders (Shleifer and Vishny, 1997; Sternberg, 2004; Cuervo, 2002) may have been justified in the context of an environment of corporate frauds (Treadway Commission, 1999), excessive salary and enjoyment of perquisites (Bebchuk and Fried, 2005; Bebchuk and Grinstein, 2005) and various ways of expropriation of shareholder funds (Shleifer and Vishny, 1997) and entrenchment practices which negate the internal and external controls of corporate governance mechanisms (Walsh and Seward, 1990). Balance sheet statements of the annual reports of PLCs[12] show that the shareholders' funds, i.e. equity capital plus retained profits and general reserves are utilised to build the corporation and how vulnerable are the shareholders to hand over the assets to a set of managers and directors who have no considerable ownership in majority of these corporations as well as who are not guided or directed closely by the shareholders as evidenced by the lack of attendance at the annual general meetings (Stratling, 2003; Birds, *et al*., 2000). Shareholders who are the residual claimants (Fama and Jensen, 1983b) resort to the exit strategy other than making their voice heard at the annual general meetings (Davies, 2002).

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[12] Annual reports of PLCs in the UK used for the collection of data explained in chapter 5.

Since 1980s, over emphasis to protect only the interests of shareholders in corporate governance is debated when there are many stakeholders such as the employees, suppliers, customers, etc. (Freeman and Reed, 1983). Luoma and Goodstein (1999) point out that by 1991, 29 states in the US have adopted stakeholder statutes, which specify that the BOD must consider the interests of non-shareholder stakeholders. Section 172 of the UK Companies Act 2006 states that the directors of a PLC must bear in mind in their functions, the interests of the employees. Employees and suppliers are considered along with many parties in the environment which affect the corporation as well as those affected by the activities of the corporation as stakeholders (Donaldson and Preston, 1995; Friedman and Miles, 2002) though the early proponents of the stakeholder theory considered stakeholders as only those who create wealth and who are affected by the corporate decisions (Freeman and Reed, 1983). Aguilera and Jackson (2003) point out that the interests of three parties must be considered in corporate governance namely the suppliers of capital, employees and the management. Aguilera *et al.*, (2006) taking a broader look through a social perspective write that 'Recognising that firms are situated within a given society and political tradition, which will influence the decisions of individuals within the firm, one can conceptualise corporate governance as relationships within the firm and between the firm and it's environment (Aguilera *et al.*, 2006:148).

Jensen (2001) explains that the interests of the shareholders as the financiers could be protected if only the interests of other stakeholders are also considered. Therefore, this author explains a widened corporate objective function called *enlightened stakeholder model*. Hill and Jones (1992) have developed the *'agency - stakeholder model'* viewing the firm as a nexus of contracts between the resource holders. They

emphasise the need to look at the various parties, which interact in the development of the corporation. Despite the increased attention for a wider corporate function, the validity of the arguments of the stakeholder theorists are questioned due to the ambiguity of the identification of the stakeholders (Stoney and Winstanley, 2001), infinite number of stakeholders (Sternberg, 1997), and difficulty of understanding the relative importance of the stakeholders especially in the context of the changing environment (Friedman and Miles, 2002).

The different levels of treatment given for the shareholders across the countries are evident when taken into account the legal protection of the rights of the shareholders between the common law and the civil law countries (La Porta *et.al;* 1998). Bhattacharya and Daouk (2002) find that insider trading law is enforced in common law countries more effectively than in the civil law countries. Therefore, capital markets in common law countries are dynamic as there is the opportunity of transfer of property rights. But in some countries where there are family holdings and pyramid ownerships as in Japan, Germany, Italy (Vives, 2000), market control is not robust and the above groups get more control rights than the cash flow rights (La Porta, De-Silanes and Shleifer, 1999). Rajan and Zingales (2000) argue that there is no need to look at the interests of the minority shareholders because their size ownership is negligible when compared with the size of the share holdings of institutional funds in PLCs and therefore they argue that institutional investors should involve in corporate governance. However, the ultimate owners of the institutional funds such as the pension funds are the minority investors (Aguilera *et al*., 2006; Vives, 2000; Agrawal and Mandelker, 1992). Stiles and Taylor (2001) point out that institutional investors held 85 per cent of the value of the stock market by 1998 and individual investors

who have invested in pension funds and insurance funds are the real owners of the investments.

Corporate governance mechanisms could be divided into two as internal and external with each of them having many variations in practice as well as social, economic and political influences on shaping them according to many researchers (Kosnik, 1987; 1990; Walsh and Seward, 1990; Agrawal and Mandelker, 1992; Jensen, 1993; Hart, 1995; Rediker and Seth, 1995; Kole and lehn, 1997; Shleifer and Vishny, 1997; Turnbull, 1997a; 1997b; Keasey, Thompson and Wright, 2000; Vives, 2000; Aguilera and Jackson, 2003; Cremers and Nair, 2005). Among the internal corporate governance mechanisms, the most important is the BOD but it is only one among many others such as the compensation strategy to align the interests of the shareholders with the managers, internal control systems such as the budget control and management information systems (Eisenhardt, 1989; Fama and Jensen, 1983a; 1983b; Turnbull, 1997a).

Composition of the BOD with executive directors and NEDs, structure of power between the chair and the CEO, that is whether there is duality or not, diversity of the BOD in terms of age, educational and professional experience are some of the variations of the BOD which could create a distinguishable culture in the board room (Pettigrew and McNulty, 1995). The above authors identify two main cultures in the boardroom as maximalist and minimalist. When there is openness, willingness to discuss and share, it is called as maximalist culture and when there is no room for such openness, it is called as minimalist culture by the above authors. Another variation is the separation of powers of the chair and the CEO in which the former

leads the BOD while the CEO is responsible for the executive management or else the holding of both functions by the same person, which is explained as a duality (Rechner and Dalton, 1991). Writing about the duality, Finkelstein and D'Aveni (1994) argue that when the firm is facing troubles in the market, duality is important as the resources and the strategy could be directed efficiently to win over the difficulties. When the firm has a good position in the market, the separation of the role of chair from the CEO role is required because the CEO gets the reputation among the peers and the business community which they argue as a way of making the path for future entrenchment in the job.

Jensen (1993) argues that the BOD has failed to understand the proper entry and exit strategies to avoid structural and cultural inertia which he proves by showing the difficulties of making exit due to over investments in some industries by PLCs. Jensen (1993:852) writes 'Ineffective governance is a major part of the problems with internal control mechanisms'. Fleming and Zyglidopoulos (2006) analysing the corporate frauds suggest that managers cover inefficiencies by deception across the organisation. In order to address inefficiencies of the BOD, many authors argue that the corporate market activities such as the hostile takeovers, market for managers and the product markets must be strengthened other than the codes on corporate governance (Cuervo, 2002; Mayer, 1997).

Therefore, Monks and Minow (2004) argue that there is still to understand about corporate governance in both developed capital markets and in emerging markets. Krishnamurti, Šević and Šević (2005) find that the firms in emerging countries are interested in listing in developed capital markets but there is a need to understand how

they perform in corporate governance in the home countries when their firms are required to abide by the enhanced disclosure regimes in the developed capital markets. Piesse (2005:48) points out to whether 'Models of corporate governance can be imported.'

Among some other vital areas are the investigations of corporate governance in non-profit organisations, which compete with profit making firms (Fama and Jensen, 1983a; Jensen and Meckling, 1976; Piesse, 2005; Vives, 2000; Keasey, Thompson and Wright, 2000). Demirag, Sudarsanam and Wright (2000:351) argue the need for 'International comparisons of the effectiveness of statutory versus voluntary codes of corporate governance'. The relationship of the chair and the CEO and how this relationship affects on board relations and the performance (Stiles and Taylor, 2001; Kakabadse, Kakabadse and Barratt, 2005), and cognitive behaviour of the BOD (Rindova, 2003; Forbes and Milliken, 1999; Haleblian and Rajagopalan, 2006) are also required investigation due to lack of research in these aspects. Corporate governance mechanisms of the IPOs (Filatotchev, 2005) and in small and medium scale business firms are also some other areas which need to be investigated (Westhead, 1999; Deakins, O'Neill and Mileham, 2000).

Mizruchi (2004) points out that there is a need to understand the influence of interlock directorships on various aspects of business such as political behaviour, effects on mobilisation of capital and corporate scandals. He argues vehemently that the sociologists hailed the development of a wider share ownership emerged in the US in the early 19th century (Berle and Means, 1933) but have not paid attention to the growth of the PLCs and its impact on the society in the recent decades. Piesse (2005)

in a review of papers on measures of performance and relationship of endogenous variables such as the family ownership size, and its impact of these variables on corporate governance and the wider society, writes 'The task of social research is to observe behaviour and measure the effectiveness of organisations within wider society' (2005:49).

The lack of knowledge in corporate governance is evidently pointed out by the studies of Kosnik (1987; 1990) and Mizruchi (2004). Kosnik (1987) studied the takeover market and pointed out that the NEDs prevent the execution of anti-takeover measures by the management but in a subsequent paper, Kosnik (1990) shows that the ability and willingness of prevention of the anti-takeover measures by the NEDs depend on the relative share of equity they have in companies in comparison to the compensation they obtain.

By looking at the discussion in the above section, corporate governance could be understood as the construction of a dynamic and flexible institutional framework necessary to protect the assets of the shareholders while keeping an eye for the needs of the other stakeholders who have a direct influence on the corporation as well as who are affected by the actions of the corporations. In order to understand how such a framework could be built, the next section will discuss the major theories of corporate governance.

2.9 The Need of Corporate Governance

Jensen and Meckling (1976) explain that the management style of the owner-managed business firm changes when several shareholders are taken as co-owners. If the owner himself manages the business, the right to decide what to do with the cash flow and to what extent the business is to be expanded can be decided according to his preferences of risk. The control rights and privileges such as the appointment of employees, donations to charities, the ability of deciding whether to open the business or to go on holiday, etc. is decided by the owner himself. However, there is a problem facing the single owner due to the inability to find capital to expand if the retained earnings are not adequate (Marris, 1998). A further limitation is the lack of managerial skills. There are solutions for these limitations as well as the solutions themselves are significant in corporate governance as discussed below.

Vives (2000) explains ways and means of overcoming these limitations. 'The limits on size can be penetrated by changing the structure of the firm. By corporate reorganisation, the autocratic figure of the founder is replaced by a management team and the financing problem is eased by acquiring shareholders. … thus by going public (A British expression for the conversion of a closed corporation into an open one), traditional enterprises can continue to grow in a new form and this has been the origin of established public corporations' (Vives, 2000:7). While the limitations of capital and management skills in the owner managed firm could be met by the expansion with the ownership being broad based and the appointment of specialised management, agency problems could arise eventually as a result of the separation of

ownership and management in large corporations (Fama and Jensen, 1983a; 1983b). These agency problems were discussed in the introductory section of this chapter.

In the PLCs existed in the 19th century, behaviour of managers was easily scrutinised as observed by Berle and Means (1933). They write that 'We have the picture of a group of owners, necessarily delegating certain powers of management, protected in their property rights by a series of fixed rules under which the management had a relatively limited play. … they were strictly accountable and were in a position to be governed in all matters of general policy by their owners' (Berle and Means, 1933:135). In modern corporations also, when there are a substantial number of shareholders, some authors argue that in order to ensure regular supply of capital, interests of minority shareholders are protected and thus the substantial owners involve in direct management and are effective in mitigating the agency costs (Shleifer and Vishny, 1997; La Porta, De-Silanes and Shleifer, 1999; Claessens and Pan, 2002).

There are a number of reasons identified for the general lack of interest by the minority shareholders in corporate governance. They are the dispersion of ownership and dispersion of risk across several portfolios (Fama and Jensen, 1983a) and lack of time commitment to understand the corporate activities due to their individual and social commitments (Stratling 2003). Minority shareholders find it difficult to understand the nature of the present corporation, which has various types of businesses such as out sourcing and assembly lines situated across the world (Vives, 2000; Luo, 2005a). Complex information systems of the modern PLCs (Turnbull, 1997b) when compared with the corporations studied by Berle and Means (1933)

which were mostly vertically integrated and located in a particular geographical area is another complexity in the modern corporation. Therefore, the minority shareholders are more willing to sell their shares (exit mechanism) if their stocks do not perform rather than questioning the management (voice mechanism). Monks and Minow (2004:105) write 'The inability to use voice to influence corporate activity made exit the only option'.

The problem of the shareholders may not only the inability and the time required, but also the availability of information on the performance in the corporation. However, the NEDs find this information asymmetry as a barrier for effective corporate governance and they are pushed towards financial control rather than the strategic control of the corporations (Forbes and Milliken, 1999). When the minority shareholders are reluctant to come forward to involve in corporate governance activities, large shareholders could get an extra benefit (both individuals and institutions) as they are interested in control rights more than the cash flow rights. There could be negligence for the interests of the minority shareholders as the large shareholders are able to take strategic decisions to suit their private interests' even (La Porta, De-Silanes and Shleifer, 1999; Clyde, 1997; Agrawal and Mandelker, 1992; Pozen, 2003).

Separation of management from ownership is an important issue in corporate governance due to different interests and risk preferences between the shareholders and the managers. Jensen and Meckling (1976) write that 'If both parties to the relationship are utility maximizers, there is good reason to believe that the agent will not always act in the best interest of the principal' (Jensen and Meckling, 1976: 308).

Schwartz (1983) points out that the corporation is usually managed for the welfare of the shareholders but by serving the shareholders, the managers tend to serve themselves at the same time. Other than determining the salary and other perks by the managers themselves, author points out several self serving behaviours '… resistance to efforts to change control; in the acquisition of property; in the decision whether to emphasise the long term or short term goals of the corporation' (Schwartz, 1983:56).

Williamson (1993) argues that the managers are not trustworthy and opportunists. '… not only are the failures to self-disclose true attributes *ex ante* (adverse selection) and true performance *ex post* (moral hazard) both subsumed under opportunism, but the failure to tell the truth, the whole truth and nothing but the truth is implicated by opportunism' (Williamson 1993:101). Chalmers, Dann and Harford (2002) argue that the managers have privileged information on future earnings and strategic choices in different environmental scenarios. Therefore, the managers get insurance cover in order to be safe by litigation by the shareholders if the company faces financial problems with the execution of a strategy which failed to generate cash flow. Therefore the above authors argue that managers of the IPOs even behave opportunistically.

Das (2006) and Luo (2006) point out that the inter-firm cooperative arrangements are deliberate attempts to seize private benefits. However, Hendry (2005) argues that the shareholders are also opportunists as they change the property rights or sell the ownership of the shares without any notice for the managers and leaving the managers' jobs in danger because the decisions of the new owners are beyond the ability of the managers to think in advance. In extreme cases, the new owners would

even go to the extension of removing some of the managers and even the present BOD.

Eisenhardt (1989) argues that to a certain degree, agent behaviour can be monitored with the preparation of a contract of employment giving some guidelines and expectations of the job. But excess monitoring with a rigid set of guidelines could result in the alienation of top management because in a competitive market situation managers are required to be dynamic, flexible and take important decisions to seize the market opportunities (Davis, Schoorman and Donaldson, 1997). Turnbull (1997b) points out that a regular flow of information could be built such as budgeting, reporting procedures and management information systems to discipline the managers. Shleifer and Vishny (1997) argue of the need to prepare a long-term contract to discipline the managers. 'A better solution is to grant manager a highly contingent, long term incentive contract *ex ante* to align his interest with those of investors' (Shleifer and Vishny, 1997:744). These authors point out that the share option plans and the incentive bonus schemes of PLCs could be identified as long term incentive contracts.

Jensen (1994) mentions that there is an imperative need to survive by both the managers and the shareholders because of corporate takeovers. In such situations, shareholders and the managers will end up only in a zero-sum game, which means neither the principals or the shareholders nor the agents or the managers will win. In order to avoid takeovers in the US market in 1980s, PLCs implemented anti-takeover mechanisms such as staggered boards and super majority votes, i.e. the need to remain a one third of the board members in the annual re-election of the board and a two third

majority of votes for a takeover respectively (Davis, 1991). External market control mechanisms such as the takeovers and mergers could stand as the last resorts to discipline the management when internal control efforts fail (Walsh and Seward, 1990).

Therefore, the shareholders and the managers understand the importance of minimising the expenditure of the contracts. '… conflicts of interests cause problems and therefore losses to the parties involved, the parties themselves have the strong motivation to minimise the agency costs' (Jensen, 1994:13), otherwise the external market control mechanisms could replace the management. Fama and Jensen (1983a) argue that in order to avoid a takeover attempt, managers specialise in decision making and decision approval is done by the BOD. According to these authors, there is a constant dialogue between the managers and the shareholders which help the corporation to survive in the market.

Despite all the above attempts to reduce the agency problem, managerial excesses can be seen since the early days of the existence of the corporations. Berle and Means (1933) identified a number of ways of expropriation of shareholder funds in the emerging corporate sector in the 19th century, that is diversion of profitable businesses to second corporations owned by the controlling corporation, use of inside information for their advantage which would lead to market manipulations, higher wages for employees and keeping luxurious office complexes, are amongst them. In the modern corporate sector too, apart from the above agency costs, authors identify several subtle ways of expropriating the assets of the shareholders (Shleifer and

Vishny, 1997; Fields and Keys, 2003; Tonge, Greer and Lawton, 2003; Davidson, Stewart-Goodwin and Kent, 2005). Some of them are implicit and others are explicit.

Recently, authors point out the excessive payments for the executives which are not comparable to their performance (Bebchuk and Grinstein, 2005; Bebchuk and Fried, 2005). Manipulation of financial information to show the shareholders that the company is making profits and insider trading and so on are some of the implicit acts which create opportunistic gains for the managers with the rise of share market prices (Fields and Keys, 2003; Davidson, Stewart-Goodwin and Kent, 2005; Tonge, Greer and Lawton, 2003).

Interlock directorships create benefits for the corporations interlocked but create barriers for the orderly conduct of the market forces. Davis (1991) finds that when there is a takeover attempt of a company in the market, if the BOD comprises more insider directors, management increases the premium of the shares. The new owners have to pay the present owners a higher price, and accordingly the takeover is made difficult. Accordingly, job survival of the managers is ensured. Agrawal and Mandelker (1992:17) argue that 'Managers of the firm have their own motives to propose anti-takeover amendments. A takeover of the firm is often associated with a replacement of the top management team. If managers lose their jobs, they not only lose their firm specific human capital but are also likely to suffer a downward revaluation of their general human capital'. However, these authors find that if the managers have substantial ownership, they even prefer a takeover plan, which suits their interests.

Even if a takeover with a higher price for the firm could be attractive for the shareholders, the moral hazard, which could create, by the new owners could not be identified as the shareholders are rarely given any explanation of the expected course of business of the new ownership (Eisenhardt, 1989). Kosnik (1987) argues that the offer of a price called greenmail for a hostile takeover attempt by a *corporate raider* is another way of expropriation. Although the rest of the shareholders also get an increase of their share value, in the long run, the shareholders are at a disadvantage as the money to pay the *corporate raider* is obtained from borrowings at higher interests rates. Ultimately, the shareholders are to pay for it against the future earnings.

Authors find number of factors, which make the managers less dependent on shareholders. The accumulated profits of the corporation make the managers not to depend on the shareholders for the needs of supplementary capital (Stiles and Taylor, 2001; Schmidt and Tyrell, 1997). Appointment of the NEDs is influenced by the CEO and getting the approval of the shareholders at the annual general meeting gives legitimacy for the appointments (Mace, 1971; Miwa and Ramseyer, 2005; O'Higgins 2002; Higgs, 2003; Reggy and Manen, 2004). However, this is not always true. When the NEDs are beyond the ability of any influence by the CEO, they become powerful over the CEO and tend to hire a new CEO firing the incumbent when the firm is not performing well (Vafeas, 1999; Fields and Keys, 2003). Mizruchi (1983) argues that the definition of the term *control* has to be re-examined in order to understand whether the BOD or the CEO is powerful in the context of the short run and the long run conduct of the CEO and the BOD. Jensen and Fuller (2002) advocate that the NEDs have to take the correct decisions in the interests of the corporation and Fama

and Jensen (1983a) argue that the NEDs maintain their reputation in firing the CEO despite the factor that the same CEO recruited the NEDs.

The Stewardship theory disputes opportunism (Davis, Schoorman and Donaldson, 1997). This theory is based on a number of sociological and psychological theories, which see the *man* as a collectivist with a tendency to work towards the goals of the organisation. The foundation of the stewardship theory is the motivational theories. Motivational theorists point out that the *man* has higher achievement needs and once the lower levels of needs are satisfied, the need to reach for higher order of needs arises such as self esteem and self actualisation (Maslow, 1970). Satisfaction of the lower level of needs such as food and hunger (physiological needs) alone do not motivate the *man* (Herzberg, 1972), but the higher needs mentioned earlier. The need for achievement[13] has been pointed out by McClelland (1962; 1975) as the single most powerful factor behind the growth of PLCs and a professional management cadre in the US.

The behaviour of the executives, which have higher achievement needs, is believed to be pro-organisational (Hendry, 2005). The cost of monitoring, bonding and controlling of the executives can be diminished by such behavioural tendencies. It is important to empower them and make them more autonomous to achieve the organisational objectives. If there are advantages of the stewardship model of

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[13] McClelland (1962; 1975) points out that the 'need for achievement' was the force, which drove the US to be a wealthy country, and is a need for a corporation to be competitive. He argues that there are three needs: Need for achievement, need for affiliation and need for power (Three N'Ach). 'Need for affiliation' discourages a person to be successful in a business life as the person is more towards the family life and the person driven by 'power need' becomes a politician according to his thesis.

governance, the reason for the lack of attention for the theory is the proportion of risk assumed by the principals (Davis, Schoorman and Donaldson, 1997). Owners who have a propensity to think of the risk of managing the assets by managers and also the lack of trust on them (Welch, *et al*., 2005), would tend the principals to think of controlling and monitoring the behaviour of managers. Trust is an asset and also difficult to build up unless there is an effort as Welch, *et al*., (2005:457) write: 'Social trust is the mutually shared expectation, often expressed as confidence, that people will manifest sensible and, when needed, reciprocally beneficial behaviour in their interactions with others'. Trust is a key decision of recruiting NEDs especially in the small and medium sector companies as they need mentoring more than the control aspects (Boussouara and Deakins, 2000). Trust is one of the key factors in developing networks essential in modern day business world to position the company and the products in the market place, information search for corporate planning and to acquire resources economically. Thus trust is vital in strategic development of a firm (Thorelli, 1986; Borch and Huse, 1993).

There are several theories to identify the stewardship of managers. Theory of self-leadership (Manz, 1986) suggests that if the executives have self-initiatives such as designing of new systems, bringing new information, reducing wastages, etc. in the organisation, they are working for the organisational aims and they are pro organisational. They will identify the organisation as their own whenever they talk of the organisation, they prefer to talk of the organisational achievements with their friends. When they meet influential people in the industry or society, they talk about the organisation and try to bring resources and enhance capabilities of the organisation (Mael and Ashforth, 1992).

Looking at the nature of the development of the theories in corporate governance, Rindova (1999) points out the gradual development of understanding of corporate governance has taken place on a dialectical path. 'The evolution of research on boards, however, appears to follow a dialectical sequence from a thesis (manager dominated directors) to an antithesis (director should control managers). Therefore, a third stage of synthesis in which directors and managers work together toward organizational success can be expected' (Rindova, 1999:954). Stiles and Taylor (2001) summarising the principal theories in corporate governance i.e. Class Hegemony and Managerial theory (Mason, 1971), Principal-Agent theory (Jensen and Meckling, 1976), Stewardship theory (Davis, Schoorman and Donaldson, 1997), and Stakeholder theory (Freeman and Reed, 1983) point out that a single theory is not sufficient to understand corporate governance.

Above discussion pointed out some of the essential features of the principal theories in corporate governance. Filatotchev *et al.,* (2007) make a vital contribution getting the views of authors in corporate governance worldwide to identify the *key drivers in good governance.* Accordingly, they emphasise that there are seven factors which could be considered as significant elements in effective corporate governance: (1) corporate boards (board independence, diversity, human and social capital within the board and high engagement); (2) share ownership and shareholder activism (presence of large-block shareholders and shareholder activism); (3) information and disclosure (broad and deep public information disclosure and private information sharing); (4) audit and internal controls (independent external controls, highly qualified audit committees within the board and support of audit through internal control, risk management and protection of whistle blowing); (5) executive pay (long-term

performance-related incentives, transparent and independent control of the remunerations committee); (6) market for corporate control (an active market for corporate control, transparency and protection for shareholders and stakeholders during mergers and acquisitions, board power regarding takeover bids, subject to shareholder veto) and (7) stakeholders (stakeholder involvement within corporate governance, voice mechanisms for debt holders, employee participation in financial outcomes and collective voice in decision-making).

The above *key drivers in good corporate governance* (Filatotchev *et al.,* (2007) reiterate some of the models of board performance (Pearce and Zahra, 1992; Forbes and Milliken, 1999) and could be seen as a constellation of the opinions expressed in several reviews in corporate governance literature too (Johnson, Daily and Ellstrand, 1996; Shleifer and Vishny, 1997; Demirag, Sudarsanam and Wright, 2000; Denis, 2001; Gregory and Simmelkjaer, 2002). However, there are still arguments about the lack of a general theoretical body in corporate governance. McConnell (2003) finishing his keynote address to the Eastern Finance Association, tells: 'We are still in business' (McConnell, 2003:31). Hendry and Kiel (2004) point out this situation as the lack of 'overarching theoretical perspective' (Hendry and Kiel, 2004: 500). These echo the same argument raised by several authors previously (Pettigrew, 1992; Pettigrew and McNulty, 1995; Hung, 1998; Clarke, 1998).

However, these criticisms have many flaws too. For instance, Zahra and Pearce (1989) introduce a model incorporating several theoretical perspectives such as legalistic, resource agency and managerial hypothesis to an integrative model to show the relationship of number of variables with the performance of the firm. This model

corrects the defects of several theories which linked the performance of the firm with the top management characteristics such as age, educational qualifications, etc. (Hambrick and Mason, 1984), with the cognitive behavioural aspects of the management such as sense making, scanning, attributions, beliefs, perception, etc. (Rindova, 1999, Forbes and Milliken, 1999, Haleblian and Rajagopalan, 2006). However, still some authors attempt to link the relationship of demographic variables such as age, tenure and organisational demographics such as size, life cycle, etc. with the financial performance of the firms (see Dulewicz and Herbert, 2004; Randoy and Jensen, 2004).

In the above discussion, it is clear that the role of the BOD is crucial in corporate governance. The prime responsibility of the BOD is to meet the interests of the shareholders. Legally, the directors are '… bound to exercise their direction in the interests of the shareholders, while various contractual mechanisms may be deployed such as share option schemes to align the directors' interests *de facto* with those of the shareholders' (Davies, 2003:19)[14]. According to Berle and Means (1933),

> '… the stock holder has certain well defined interests in the operation of the company, in the distribution of income and in the public security markets. … first the company should be made to earn the maximum profit compatible with a reasonable degree of risk; second, that a large proportion of these profits should be distributed as the best interests of the business permit, and that nothing should happen to impair his right to receive his equitable share of those profits which are distributed and finally, that his stock should remain freely marketable at a fair price' (Berle and Means, 1933:121).

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[14] Cheffins and Black (2006) point out that legal liability is one of the factors for the motivation of outside directors to discharge their duties, but they seldom pay for any legal liability due to the coverage of their legal expenses by indemnity insurance cover in the US and UK. These authors point out that the judiciary is reluctant to interfere in business judgment except in rare cases such as Enron and World Com scandals. See Das (2006) to understand the scale of legal indemnity coverage for UK managers.

In order to ensure that the managers pay back the shareholders a reasonable return for their investments, Vishny and Shleifer (1997) point out there are several rights of shareholders. 'The most important legal right shareholders have is the right to vote on important corporate matters, such as mergers and liquidations, as well as in elections of boards of directors, which in turn have certain rights vis a vis the management' Vishny and Shleifer (1997:750). Next section will see the discussion of the role of the BOD in this context.

The role expected by the directors is explained in law as fiduciary care and loyalty. Companies Act (2006: sections 171 to 177) mentions the duties of the BOD. Some of these are found in the Companies Act, No. 7 of 2007 in Sri Lanka too, i.e. the duty to serve the company within the powers, promotion of the business, exercise judgment and exercise reasonable care. Legally, the directors are '… bound to exercise their direction in the interests of the shareholders, while various contractual mechanisms may be deployed such as share option schemes to align the directors' interests *de facto* with those of the shareholders' (Davies, 2003:19). Combined Code (FRC, 2006) mentions the role of the BOD in general terms such as the entrepreneurship, control and due care for the corporation.

> 'The board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed. The board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance. The board should set the company's values and standards and ensure that its' obligations to its' shareholders and others are understood and met' (FRC, 2006:3).

2.10 Role of BOD and NEDs in Corporate Governance

The role of the BOD is explained in many ways in academic literature. BOD is primarily required to execute three roles according to Stiles and Taylor (2001), i.e. monitoring the managers, setting the strategic frame and the service role. Monitoring of the executive directors and the CEO is the task of the NEDs since the insider directors are aligned with the management and they find it difficult to monitor CEO due to being subordinates. However, Stiles and Taylor (2001:27) argue that 'The strategic role is said to be the defining role of the board giving the term 'director' its meaning, and playing an important part in determining organization's effectiveness'. NEDs must identify where the firm has to go from the present level (*Vision*) and the way of going (*Mission*). Vision and mission guide the managers at operational and strategic level to design the suitable strategies and the acquisition of the resources as well as the allocation of them in addition as a framework of discipline. Because of these significant tasks, the BOD is explained as the apex of the firm's decision control system by Fama and Jensen (1983a). The service role of the NEDs includes giving advice, spanning the boundary of the firm, institutional services such as representation of the firm in internal and external environments such as at discussions with the officials of the government and representation of the PLC at social and economic events.

Mintzberg (1983) lists seven roles for the BOD: (1) selecting the CEO; (2) exercising direct control during periods of crisis; (3) reviewing managerial decisions and performance; (4) coopting external influencers; (5) establishing contacts and raising funds; (6) enhancing the organisation's reputation and (7) giving advice to the

organisation. Many authors point out the significance of the resource function of the BOD especially for new firms and small and medium scale companies in establishing legitimacy and introducing the vital market and financial resources to compete with established firms in the market (Singh, Tucker and House, 1986; Neilsen and Rao, 1987; Burt, 1997; Jensen and Greve, 2002).

The significance of the BOD for the growth and the survival of the corporation are explained by Thomas (2005) paying attention to the qualitative and quantitative aspects of the BOD. 'The BOD should be the heart and soul of a company, the sources of its ambition, inspiration and drive. Whether or not a company competes and wins, sustains success and remains relevant and vibrant usually depends on its' board. Their actions demonstrate they care' (Thomas, 2005:3). Mori study[15] (Mori, 2003) found that there is hardly any system of evaluation in the UK on the performance of the NEDs but the Higgs review (Higgs, 2003) has made many proposals to evaluate the performance of the NEDs. These proposals have been incorporated in the Combined Code (FRC, 2006).

Roberts, McNulty and Stiles (2005) emphasise the need to create accountability within the BOD by the NEDs in making an effective dialogue at the BOD meetings. Accordingly, NEDs could be effective if only they pay attention at the BOD meetings in challenging as well as questioning appropriately about the assumptions of the managers while supporting them. They caution that the NEDs must understand about their non-executive function and must have an incremental approach with a mindset

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[15] This study provided the background information about the population of directors in the UK and the report could be considered as the first ever studies on this aspect in the UK.

of an '*experienced ignorance*' which they put it as '... just by asking the idiot-boy questions' (Roberts, McNulty and Stiles, 2005:14). However, whether a reputed director (Fama and Jensen, 1983a) would field 'Idiot-boy questions' (Roberts, McNulty and Stiles, 2005:14) is doubtful because as Baumeister and Exline (1999) argue, successful people are 'Prideful' (1999:1173) which results in self focused and independent in acquisition of knowledge which could even not be in the interest of the firm. However, Useem (2003) explains how a corporate failure happens as well as how a corporate failure could be avoided with probing and challenging the assumptions of the managers explaining the experience of number of corporate collapses and turnarounds in the US including Enron scandal.

However, a NED is not in a position to get on with the job of a NED unless there is a strategy to get prepared and familiarised with the new appointment as well as with the internal and external environment of the company (Presthus, 1958). There are different factors of success they experience in their particular roles in the companies they worked prior to take up the NED posts (Rodrigues and Hickson, 1995). Stiles and Taylor (2001) argue that the correct perception of the executives on the NEDs is important because 'Executives' attitude to non-executives ranged from suspicion that they were simply policeman on the board who served to public little in the way of added value, to the perception that they provided a valuable service in terms of advice and counsel as well as contacts and sources of external influence' (Stiles and Taylor, 2001:109).

Nicholson and Kiel (2004) point out the BOD as a key link to the external environment and identify three key roles: as a cooperative mechanism to access

resources vital to the organisation, as a boundary spanner and as a legitimate organisation. Hung (1988) supports this idea by introducing six roles linking the organisation to the external environment. They are: coordinating the interest of shareholders, stakeholders and public, controlling the behaviour of management to ensure organisation achieves its objectives, strategy formulation, maintenance of the status quo of the organisation and supporting the management.

In the recent years, there is a growing emphasis on the significance of the cognitive orientations of the directors (beliefs, assumptions or considerations, expectations) rather than the pure demographic factors such as age, qualifications, and experience in corporate governance. Hambrick and Mason (1984) write that behavioural dynamics in and around the boardroom represent one of the keys to effectiveness of NEDs and this is a crucial ingredient in shaping the conditions for board and managerial accountability. Rindova (1999) points out the significance of the aspects of scanning the environment. In recent years, many authors have given strong emphasis to understand the cognitive behaviours of the BOD such as the significance of the beliefs, attributions, considerations or assumptions, expectations, and so on (Rindova, 1999; Forbes and Milliken, 1999; Haleblian and Rajagopalan, 2006).

Forbes and Milliken (1999) and Hendry and Kiel (2004) point out that the BOD has to see the future of the business through the development of strategic awareness among the managers. Hendry and Kiel (2004) identify strategy as '… a shared frame of reference within an organisation, providing the basis for an iterative process of objective setting and resource allocation' (Hendry and Kiel, 2004:501). The process of strategy formulation integrates different functional areas of the corporation such as

marketing, purchasing and finance. Therefore, the managers and the BOD have to build an effective and efficient working relationship to prepare a successful strategic plan (Pearce and Zahra, 1991).

Board diversity (Fields and Keys, 2003), which means the constitution of a BOD with varying levels and types of skills, age, gender, ethnic diversity, and so on create a necessary environment to balance the various pressures and to enhance cognitive development of the BOD (Forbes and Milliken, 1999). However, Sundaramurthy and Lewis (2003) discuss in length that such diversified BODs should have a unified decision that has to come with the required deliberations and with independent thinking of all the members. Therefore, understanding and trust among the members of the board is required when the board is holding opposing views. Otherwise, there will be chaos in the BOD and lack of agreement would lead to poor choices and delays in decision taking. In the long run, the company would not be competitive in the market place. Sundaramurthy and Lewis (2003:397) write ' ... stressing one polarity exacerbates the need for the other, often sparking defenses, impending learning, and engendering counter productive reinforcing cycles. Managing paradox in contrast entails developing understandings and practices that accept and accommodate tensions.' But they argue that the diverse boards bring new insights into the board by creative debates though the diversity brings a challenge for collaboration.

A synthesis of several arguments of above has been brought under a concept explained as corporate directing by Pye (2002a). According to this author, three aspects come under corporate directing: governing, strategising and leading.

Corporate directing includes, 'More than just board behaviour and includes all aspects of directors' communications, both explicit and implicit as well as inside and outside their organisation in the process of shaping their organisation's future' (Pye, 2002a:155). Pye (2002a) sees corporate governance through a new perspective. 'Governance implies something static and a box that can be ticked, whereas governing implies a social process and collective phenomenon, i.e. done with and through relationships with other people' (Pye, 2002a:156). Pearce and Zahra (1991) point out the importance of warm relationship between the participants in governance. These findings make us to understand that the role of the BOD is complex and it has to deal with a multitude of tasks other than the monitoring and controlling proposed by the agency theorists (Eisenhardt, 1989). Handbook of the Institute of Directors (IOD, 1995), had incorporated many of the tasks discussed above into four functions, that is (1) construction of the vision, mission and values, (2) strategy and structure, (3) supervision of management, and (4) responsibility to shareholders and other stakeholders (IOD, 1995). Dulewicz and Herbert (2004) point out that the above Handbook is a result of a postal questionnaire survey among 1,000 chairs in the UK.

However, none of the above authors have seen the role of the BOD and the NEDs through the perspectives of the *role theory* (Sarbin and Allen, 1968). The concept of role is defined in terms of another concept (Connell, 1979). 'A role is, in role theory, never defined by itself. It is defined in relation to other possible roles - mother and father in relation to daughter and son, merchant in relation to customer and artisan, etc. etc. - which can be designated counter positions. … a role frame' (Connell, 1979:11). These counter positions or 'role senders' (Rogers and Molnar, 1976:598) are many. Shareholders (Koehn and Ueng, 2005; Jong, Mertens and Roosenboom,

2006), employees (Clapham and Cooper, 2005), and debtors (Day and Taylor, 1998) are the major role senders which necessitate a wider corporate objective function (Jensen, 2001). These stakeholders have the decision power to make rewards if the position holder distributes the dividends expected by the role senders otherwise, the punishments such as the removal from directorships (Connell, 1979). Due to the wide variety of stakeholders, Johnson, Daily and Ellstrand (1996:432) point out that it is required to understand the board role as a 'social construction'.

If the nature of the role of NEDs is emphasised through the perspectives of the role senders, namely, the shareholders, managers, employees and customers to name a few among many stakeholders, there could not be any ambiguity in the role of the BOD (Rogers and Molnar, 1976). As a result, preparation of the managerial contracts to a certain extent is also possible (Eisenhardt, 1989). However, there is a difficulty of identification of the role senders exactly (Stoney and Winstanley, 2001), due to the large number of role senders (Sternberg, 1997), and the difficulty of understanding the relative importance of the role senders (Friedman and Miles, 2002).

2.11 Measuring the Effectiveness of the BOD and the NEDs

Above discussion pointed out the important tasks of the BOD as well as the complexities of the role of the BOD. However, there is still to come to a general agreement of measuring the effectiveness of these roles and also a system of checks and balances to see whether the BOD is paying attention to the role they have to play (Walsh and Seward, 1990). These authors point out the difficulty of attributing the performance of the corporation to a particular task that is whether it is a result of

monitoring or incentives or else due to the expansion of the resource base of the company. Networks bring resources for the business such as information sharing, advice (Cross, Borgatti and Parker, 2001; Hong, Kubik and Stein, 2004), and business opportunities (D'Aveni and Kesner, 1993; Davis and Greve, 1997; Das, 2006). Social capital binds the managers' together (Feldman, 1981; Grossetti, 2005; Kadushin, 2002; Katz and Kahn, 1978). Social capital mainly consists of the networks in the business community and the resources these contacts share among each others. Information sharing and unity in standing of them together provide them with a shield against any threats for them either from the regulatory or non-regulatory environment (Ornstein, 1984; Davis, 1991; Thorelli, 1986).

Hillman and Dalziel (2003) find the difficulty of measuring the contribution of the managers and the BOD differently to each other. They argue that when the corporation has good performance, it is attributed to the contribution of the BOD and when there is bad performance either the managers or the business environment are made responsible. CEO also does the same in blaming the NEDs and the business environment when the performance declines. These self-fulfilling prophesy inevitably impact on the long run performance of the company. These problems could be further worsened if the size of the board, composition, behavioural tendencies such as perception and attitudes, which have an impact on the performance of the firm is not in the proper mix (Angle and Perry, 1981; Feldman, 1981; Barhhart, Marr and Rosentien, 1994; Dalton, Johnson and Ellstrand, 1999; Stiles and Taylor, 2001; Berge and Levrau, 2004; Duelwicz and Herbert, 2004; Craven, 2006).

Research has found that there is no relationship of the financial performance and the BOD (Dan, *et al.,* 1998; Dalton, Johnson and Ellstrand, 1999; Dalton, *et al.*, 2003; Daily, Dalton and Cannella, 2003; Dulewicz and Herbert, 2004). Financial performance is a result of many factors both in the internal and external environment of a firm. Pettrigrew (1992) points out the difficulty of separating the various factors, which affect the BOD performance. Kesner and Johnson (1990:329) argue that 'Testing the relationship between board composition and firm performance does not address whether directors fulfil their duties of monitoring top management and insuring stockholder representation'.

Therefore, any study, which attempts to see the relationship of BOD and the financial performance of a firm, would not give a correct picture of the performance of the corporation (Dan *et al.*, 1998). These authors argue that the financial accounting measures. '… are subject to manipulation, may systematically undervalue assets, create distortions due to the nature of depreciation policies selected, inventory valuation and treatment of certain revenue and expenditure items, differ in methods adopted for consolidation of accounts and lack of standardisation in the handling of international accounting conventions' (Dan *et al.*, 1998:274). Piesse (2005:34) argues that 'Although most large investors may believe that corporate governance is a necessary precondition for good financial performance, a clear causal relationship has not yet been developed'. This author points out that institutional failures give more knowledge about the critical factors of success. Stiles and Taylor (2001:21) argue the need to have a different way of doing it. '…much energy has been expended in testing theoretical models, using secondary data chiefly on company performance, while few descriptive studies have actually been carried out with directors themselves'.

However, Barnhart, Marr and Rosentien (1994) argue that the BOD composition and the overall performance are related. Daily and Dalton (1995) argue that the firms which face bankruptcy in the near future invite the NEDs to join the board and replace the existing board members mainly the executive directors to prevent corporate failures. Useem (2003) names the NEDs who are inactive in corporate governance as *impotent* NEDs. Mace (1971) wrote that a mere visit to the office by a NED is enough because that gives a signal for the management to behave well.

Jenssen and Randoy (2004) have investigated the relationship of NEDs and the firm performance in highly competitive and less competitive industries in Sweden. They have found that BOD independence reduces firm performance in industries with highly competitive product markets but BOD enhances firm performance among companies, which face less competitive product markets. They measure independence of the NEDs by 'the per centage of independent outside directors on the board' (Jenssen and Randoy, 2004:283). They relate the number of NEDs with Q ratio. Concept of independence has number of qualitative aspects (Higgs, 2003). Numerical value given for a qualitative variable like independence or integrity of management and so on with a quantitative variable like Q ratio would give a certain value statistically significant but questions the meaningfulness of the association of the variables. The variables must have certain properties not merely the statistical relationships (Bowers, 1991; Cooper and Schindler, 2003).

Collier (2004:16) argues that 'How groups of senior people work together is something that has simply not been done on a regular and systematic basis'. In the

unitary board system in the UK (Conyon and Muldoon, 2006), decisions are taken collectively. Pye and Pettigrew (2005) point out that boards are classic examples of group process, and like many organisational decision making groups, their outputs are often less than the sum of parts. Rindova (1999:955) wrote that corporate boards are 'nested structures'. Effective boards might best be described as those '… that amount to more than a summing of individual contributions and where the dynamic of different people working together in a board-level way genuinely adds value to the organisation. This element of board performance is still largely under researched, and remains poorly theorized' (Pye and Pettigrew, 2005:32). Pye (2001) gives us a way of seeing the performance of the director in the above challenging problem of separating the performance of the NEDs from the executive directors. Pye (2001) and Pye (2002b) point out that there is a need to look at the career of the same director over a considerable period but point out the difficulties of locating the same director when leaving the present PLC and also the impact of the new work environment and the tasks in the new appointment.

However, there are number of proxies used to measure the effectiveness of the NEDs. Kosnik (1987) finds the ability of the NEDs to prevent the management paying a higher price above the market price for a takeover attempt. Helland and Sykuta (2005) argue that when the BOD has effective NEDs, the corporation is facing fewer lawsuits. Kesner and Johnson (1990) also find a relationship between the NEDs and the lack of lawsuits suggesting better monitoring of managers by the NEDs. However, they find that there is a tendency to step down the NEDs from the director appointments due to the increasing number of lawsuits following the corporate collapses, which awakened the shareholders. However, Beasley (1996) finds the

corporations increase the presence of NEDs in their boards since early 1970s. Miwa and Ramseyer (2005) too point out that the appointment of NEDs for a PLC is a legal requirement. IF there are no NEDs, a firm violates the listing rules.

Perry and Peyer (2005) find that the market value of the firm increases if the effective NEDs are recruited. However, there is a qualification, i.e. if only the firms, which they have served before joining, have increased the shareholder value. There is another qualification needed. The effectiveness of NEDs depends on the agency problem of the firm and the new NED appointments result in share price increases in firms where there are agency costs (Lin, Pope and Young, 2003). The composition of the BOD especially when there is diversity in terms of many characteristics of the members of the BOD brings positive results to the firm not only financial but also non measurable benefits such as mutual support between the employees (Fairchild and Joanne, 2005). Long, Dulewicz and Gay (2005) write that the cross-sector experience allows NEDs the opportunity to contribute effectively and appropriately, and to measure and evaluate their contribution in the context of each individual boardroom. Fields and Keys (2003) point out the ability of detecting *earnings management* by such diverse BODs[16]. However, if the size of the board is large, these benefits could not achieve due to the disarray of opinions, instead lack of cohesiveness arises (Jensen, 1993).

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[16] *Earning management* is defined by Security and Exchange Commission, US (1999) as 'The practice of distorting the true financial performance of (a) company' (Davidson, Stewart and Kent (2005:243). Leuz, Nanda and Wysocki (2003:506) define it as: 'The alteration of firms' reported economic performance by insiders to either mislead some stakeholders or to influence contractual outcomes'. Healy and Wahlen define it as (1999:368). 'Earning management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers'.

There are a few studies to understand from where the NEDs originate. O'Sullivan (2000) examines the extent to which the senior executives are utilised as NEDs in large UK companies. The average number of NED posts held by an executive is 0.22 according to this author and 85 per cent of executives hold no additional directorships. Booth and Deli (1996) reported that the mean number of outside directorships held by CEOs in 1989 was 1.87 in the US. These findings are similar to what Cosh and Hugh (1987) found early in relation to the directorships in large corporations in the US and the UK.

Higgs (2003) finds that from a total population of 3,908 individuals holding NED directorships in the UK listed companies, 80 per cent were holding only one post, leaving 782 individuals holding more than one executive post. Ward (1998) reports that the regulations of the companies to work outside the company are a barrier for many executives to take up NED directorships. However, Combined Code (FRC, 2006) insists the value of exposure to several corporate boards but restricts such appointments. Code provision A.4.3 insists that a chair of a FTSE 100 company should not get a second chairmanship of a FTSE 100 company and code provision A.4.5 states that the board should not agree to a full time executive director taking on more than one non-executive directorship in a FTSE 100 company nor the chair of such a company (FRC, 2006). Although Mace (1971) and Ezzamel and Watson (2000) argue that the additional directorships of the CEOs and the NEDs are at the expense of the shareholders' interests, Fich (2005) points out that the CEOs see the relative cost and benefits of the directorships for the company they serve before getting the directorships.

O'Sullivan (2000) finds that the strength of board monitoring in the executive's company, executive tenure and company size are decisive factors, which influence the decision to take directorships by executives. O'Higgins (2000) points out the importance of the networks and trust in appointments. Fich (2005) explains that CEOs of well performing firms get more chances of getting the directorships and the author points out that when such CEOs join a firm as NEDs, the abnormal share prices go up in both firms. Westphal and Stern (2007) explain that outside directors watch how the fellow directors both inside and outside perform in the boardroom such as how they question the CEOs, probe the issues and challenge the assumptions of the CEO. Those who field clever questions to the CEO are invited by the outside directors who watch them, to take up appointments as outside directorships in their companies and nominate to directorships in other companies. These findings prove the arguments of the significance of reputation in the managerial labour market (Fama and Jensen, 1983a: Ferris, Jagannathan and Pritchard, 2003). Next section explains the degree of acceptance of the codes on corporate governance.

2.12 Best Practice Codes on Corporate Governance (Cadbury, 1992; Combined Code: FRC, 2006)

Cadbury (1992) focused on financial reporting and controls of a corporation. It recommended the appointment of NEDs to comprise at least half of the BOD and independence of NEDs. Cadbury (1992) emphasised two tasks for the NEDs. First is the review of the performance of the BOD and the CEO. Second is to resolve the potential conflicts of interests. Cadbury (1992) points out that there could be conflicts among the executives and the shareholders of the firm on issues such as takeover bids,

succession of the directors or director's pay (Cadbury, 1992: provisions 4.4 to 4.6). We identify these problems as perennial corporate governance problems as they have been in the corporate sector since the beginning of the modern corporations (Berle and Means, 1933; Chapman, 1986).

Jensen (1993) argues that the directors themselves must scan the environmental changes to map out strategies to avoid failure of PLCs. Jensen (1993:852) writes that 'They seldom respond in the absence of a crisis'. However, it is not only the lack of BODs of firms who are negligent of management of change (Drucker, 1974; 1994; Siegal *et al.,* 1996) but also the responsible regulatory 'authorities' (Jones and Pollit, 2003:2). Stiles and Taylor (2001) show that the company law in the UK came upon a comprehensive law reform in 1998 for the first time since 1898. Jones and Pollit (2003:5) argue that 'This renewed interest has come after a series of high profile scandals – Enron, WorldCom, Tyco – of large US based companies in which poor corporate governance seemed to be a factor. … if only to check in the UK that all had been done to reduce the risk of it happening here.'

The role of the directors discussed by authors (Pearce and Zahra, 1991; Forbes and Milliken, 1999; Stiles and Taylor, 2001; O'Higgins, 2002; Pye, 2002a; Fuller and Jensen, 2002; Nicholson and Kiel, 2004; Thomas, 2005), i.e. monitoring of managers, strategic attention and functions such as representation of the firm, advice the CEO and spanning the boundary and so on has been emphasised by the Combined Code (FRC, 2006).

> 'The board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed. The board should set the company's strategic aims, ensure that the necessary financial and human resources

> are in place for the company to meet its objectives and review management performance. The board should set the company's values and standards and ensure that its' obligations to its' shareholders and others are understood and met' (FRC, 2006:3).

Useem (2003) sees the significance of such policy prescriptions in the context of the collapse of the Enron Corporation as follows. 'Policy prescriptions are intended to focus directors on critical challenges and provide them with full and unbiased information for reaching decisions, regardless of how many directors and who they are. Governance policies … shape the quality and timeliness of the board decisions' (Useem, 2003:243).

The words 'obligations to shareholders and others' (FRC, 2006:3), could be understood as incorporating many stakeholders but it is not clear in the context of the academic definitions of the stakeholders (Freeman and Reed, 1983). The stakeholder view of management points out the key stakeholders which decide the survival of the corporation as 'Those groups without whose support the organisation would cease to exist' (Freeman and Reed, 1983:89). Although there is no clear definition in the Combined Code (FRC, 2006) about the 'others', the need to work as a team has been emphasised in it and the decisions have to be taken objectively. Within the board, the NEDs are expected to make a constructive challenge.

> 'As part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on strategy. ... should scrutinise the performance of management in meeting goals and objectives and monitor the reporting of performance. ... satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible' (FRC, 2006:3).

Roberts, McNulty and Stiles (2005) emphasise the need to be challengeable at board meetings by the NEDs but supportive to executives within the unitary board system.

Stiles and Taylor (2001) point out the complexities of the behaviour of executives, which they identify as some becoming *in-group* and some becoming *out-group* to the CEO. Those who are *in-group* become the closest associates and the advisors of the CEO. Therefore, clear perception of the NEDs as well as the executives at each other is important to develop a good relationship in the unitary board system in the UK (Conyon and Muldoon, 2006) but at the same time there is a danger of cohesiveness and groupthink (Forbes and Milliken, 1999; Jensen, 1993).

Among internal corporate governance mechanisms, audit committee is useful to ensure that PLCs maintain accounting and auditing standards (Goodwin and Seow, 2002). Audit committee should comprise only the NEDs (Cadbury, 1992; Sarbanes - Oxley Act, 2002; FRC, 2006). Audit committee should monitor the integrity of the financial statements, review the internal financial controls and risk management strategy. In addition, it is required to see the functioning of the internal audit function and take decisions related to the external auditor such as the decisions on the appointment, fees and evaluation. Beasley (1996) finds that the individual NEDs in the BOD are more important than the audit committee as a whole in finding the errors of disclosures which the author categorises into two as misleading financial statements and misappropriation of assets by top management. The Combined Code (FRC, 2006) stresses that the audit committee should verify the accuracy of the remuneration report published within the *corporate governance report* of the PLC. The annual reports of the PLCs should include a *report on corporate governance* explaining how the BOD operates: number of meetings and attendance, remuneration and incentive payments, change in directorships and interests of directors (FRC, 2006).

The decisions of the remuneration committee are important for many reasons. Among them ranks first the preparation of the incentives for the managers. The package of compensation could be either 'outcome based or behaviour based' (Eisenhardt 1989:58) to align the interests of the shareholders with the managers (Jensen and Meckling, 1976; Fama and Jensen, 1983a and 1983b). If a greater part of the executive remuneration is based on financial targets achieved such as predetermined sales turnover and profits (Outcome based behaviour), managers take a risk in the business. If they take excessive risks, their employment as well as the survival of the firm even could be at stake if the firm faces problems in the markets. If they do not take a risk, they will not be able to achieve predetermined targets. Therefore, there is a risk and return trade off. If a greater part of the managerial remuneration is based on current performance such as the value of current sales as in the case of sales representatives, managers take excessive risks which could make a risk for the firm but greater income for them (Behaviour based income) (See Eisenhardt, 1989).

When an executive director is selected by the nomination committee, and when such appointed director takes decisions for the company, what ever the decision and the consequences of the decision, all the directors are bound for that decision and the company takes the responsibility due to the unitary nature of the board in the UK (Conyon and Peck, 1998; Davies 2002; Ridley 2002). This shows the importance of the decisions of the nomination committee.

When we see the above discussion so far, we have a good picture to see that there are number of developments such as the increasing number of research papers as well as prescriptive literature to ensure good corporate governance. Next part will discuss to

how far the expectations of the investor community and the regulatory authority has come to a reality with the implementation of the non-regulatory codes on corporate governance in the UK. It is required to mention here that the authors have devoted much time to see how the Cadbury (1992) guidelines have affected corporate governance. In the US, there are studies on the effect of the *Sarbanes-Oxley Act, 2002* and therefore, we would discuss them too[17].

2.13 Implementation of the Regulatory and Non-Regulatory Codes on Corporate Governance

Some authors point out that the implementation of the above discussed codes on corporate governance (see figure 2.1), are an ad hoc solution for corporate governance problems (Jones and Pollitt, 2003; Kirkbride and Letza, 2004). However, some others point out that it is required in the midst of corporate governance problems (Hart, 1995; Cuervo, 2002; Stenberg, 2004; Randoy and Jensen, 2004; Mayer, 1997). The success of the implementation or the acceptance of the codes by the PLCs has to be understood with the Cadbury (1992) because it is a precedent to Combined Code (FRC, 2003 and FRC, 2006).

Spira (1999) has studied the usefulness of the suggestion of Cadbury (1992) to have audit committees in the PLCs and argue that the audit committees compel the directors to behave ethically, especially not to interfere in preparing the corporate accounts. Dahya, McConnell and Travlos (2002) have found the significant impact of

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[17] To understand the implementation of Codes on Corporate Governance in Europe, see Gregory and Simmelkjaer (2002).

the Cadbury (1992) on the performance of the corporation in terms of the impact it has created for the CEOs to be self-disciplined. They identify that the CEOs who have not given much attention for the Cadbury (1992) could not survive in the corporations but those who had changed the board such as the separation of the board chair and the CEO role could record impressive growth in the share prices as well as the general business performance. Pass (2004) explains an increasing trend of accepting the Cadbury (1992) and suggests that it is required to allocate more time by the NEDs for their involvement in a PLC and stresses the need to have more information for them as well as an increase in their compensation to make the NEDs motivated.

Spira and Bender (2004) have a useful explanation of the growth of the NEDs since 1970s up to the present day and see a need to increase the availability of the NEDs in the context of the implementation of the Codes on Corporate governance by the firms. These two authors compare and contrast the various sub-committees and after their interviews with NEDs, they have found that the NEDs do not have a role ambiguity as found by Ezzamel and Watson (2000). Appointment of NEDs has been able to protect the assets of the shareholders from possible attempts of accounting malpractices in many corporations (Fields and Keys, 2003; Davidson, Stewart-Goodwin and Kent, 2005). Accounting malpractices rank high among the major corporate governance problems experiencing world wide (Shleifer and Vishny, 1997). The lack of an efficient legal environment in many countries (La Porta, *et al;* 1998), exploitation of minority shareholders by large shareholders who get a rent from control rights (La Porta, De-Silanes and Shleifer, 1999), and the lack of implementation of insider trading laws aggravate the corporate governance problems (Bhattacharya and Daouk, 2002).

Knapp, Fister and Belden (2005) find that the appointment of NEDs results in higher dividends. They point out that as a result of more dividends, shareholders are in a position to get the desired benefits and also reduce the agency costs. If not for the dividends, the cash flow surplus would have been spent in other things such as expansion of the business, more beautiful office complexes, and higher salaries to the employees to increase the pride of the professional staff (Berle and Means, 1933). Their study suggests that the agency theorists, Jensen and Meckling (1976) and Fama and Jensen (1983a) are correct in prescribing the appointment of NEDs to mitigate the agency problems.

Helland and Sykuta (2005) argue that when there are more NEDs in the BOD, they are keen to protect the interests of the shareholders as such the corporations spend fewer resources for lawsuits of the shareholders. For the shareholders who are dispersed and do not discharge the duty as shareholders, the contribution of the NEDs has to be appreciated (Stratling, 2003). Even when there is a financial difficulty of a corporation which is to be discussed at the annual general meeting, the average shareholder attendance is only one per cent (Birds, *et al*., 2000).

Stiles and Taylor (2001) find that the appointment of NEDs is influenced by the CEO and the executive directors in many PLCs rather than by the independent nomination committee headed by a NED. Therefore, the effectiveness of a nomination committee is questionable according to their findings. Byrd and Hickman (1992) argue that the CEO gives an impression to the shareholders that independent directors are selected by the shareholders. Mace (1971) has experienced this situation long ago. According to O'Higgins (2002) the NEDs are appointed primarily through the known friends.

Higgs Review (Higgs, 2003) finds that nearly half of the NEDs in the UK have been appointed through personal contacts of the BOD (Higgs, 2003).

In Japan, the appointment is decided by the degree of contribution, the person can do to the corporation. Accordingly, those who have worked in the government sector or the banking sector are taken to the board because they seize opportunities of getting government contracts and bank loan facilities respectively (Miwa and Ramseyer, 2005). However, some authors argue that there is a need to ensure not only the skills and independence, but also the trust of the management and the existing BOD (Boussouara and Deakins, 2000; Welch *et al*. 2005). Therefore, a rigid formula of nomination could endanger the spirit of appointing trustworthy NEDs. Trust is a vital consideration especially in small and medium corporations as the CEOs and the existing BOD wish the NEDs to become mentors (Westhad, 1999; Deakins, O'Neill and Mileham, 2000; Berry and Perren, 2001).

Researchers have no general agreement about whether the NEDs are independent in their thinking and working in the board (Brennan and McDermott, 2004). Higgs report (Higgs, 2003) explains independence as follows.

> 'Independence of a NED can be ensured if there are no relationships or circumstances, which could affect, or appear to affect, the director's judgment. Accordingly, a NED should not be an immediate former employee of the firm; he should not have any material relationship and should not have any other relationships such as relatives working in the firm' (Higgs, 2003:37).

Roberts, McNulty and Stiles (2005) explain that the NEDs must ensure that their mind is independent in taking decisions and challenging the assumptions of the managers. They write that independence in mind will give the NEDs to be objective and unbiased

in their role. However, this is compromised due to the following twin problems: Shareholders demand the control and monitoring the managers while the NEDs have to depend on the same executives to get the needed information to control and monitor them. This phenomenon is explained as 'Independence Paradox' by Reggy and Manen (2004). If they go too far in monitoring of managers, they will keep NEDs away (Deakin and Konzelmann, 2004). Therefore, as Stiles and Taylor (2001) argue there must be a good perception among both parties.

Examining the work of the US remuneration committees, Conyon and Peck (1998) explain that in the US, the remuneration committees have increased the compensation despite the pressure of the institutional and other shareholders to lower the compensation as well as to tie it with the performance of the corporation. Reasons pointed out very often are that the NEDs themselves are executives in other corporations and also work in partnership through interlock directorships (Davis, 1991). As such they do not wish to lower the compensation of their colleagues (Vives, 2000). Boyd (1994:335) argues that 'CEO salaries have shown limited correlation to firm size or performance and have grown at a much faster rate than salaries for production workers'.

Barkema and Gomez-Mejia (1998) point out that there is a need to do more research in this area especially to justify the increasing compensation levels for the executives. They argue that, 'Adding more studies on the statistical relationship between executive pay and firm performance to the vast literature that already exists on this issue leads researchers into a blind alley' (Barkema and Gomez-Mejia, 1998:143). They stress the importance of seeing the validity of the measures of performance,

influences of the market on compensation and national culture. Many other researchers have also pointed out the importance of looking through these perspectives (Pettigrew, 1992; Dan *et al.*, 1998; Stiles and Taylor, 2001; Daily, Dalton and Cannella, 2003; Dalton *et al.*, 2003).

Some authors question the usefulness of the NEDs. Hart (1995) points out that NEDs are not efficient and effective due to several reasons: (1) lack of a significant financial interest in the PLC; (2) little time availability and (3) lack of seriousness in the duty as a NED. Hart writes (1995:682) that 'They may want to stay in management's good graces, so that they can be re-elected and continue to collect their fees'. Borokhovich, Parrino and Trapani (1996:339) argue that '… contrary to the argument that outside director incentives are better aligned with those of shareholders than inside director executives, several outside director characteristics suggest that outside directors will not necessarily act in shareholder interests'. These authors see the difficulty of maintaining independence due to the nature of their appointment which is decided mainly by the CEO and also agree with the above argument of Hart (1995). It is a must to understand that the majority of the NEDs themselves are executives or CEOs of other PLCs and the opportunistic behaviour explained earlier is therefore common for them also as they are humans (Ezzamel and Watson, 2000).

Lack of time for the NEDs (Hart, 1995) is rejected by Ferris, Jagannathan and Pritchard (2003) who find that the executives who have multiple directorships gain knowledge and in turn they contribute in many ways such as creating links to the external firms and vital information to the firm for decisions. Because of the sharing

of information by the NEDs across the interlock companies, Haunschild and Beckman (1998) suggest a theory of inter organisational information.

Adding another dimension to the pessimistic views on NEDs mentioned above, Laing and Weir (1999) find that there is no relationship between the improved governance mechanisms and the firm performance. They argue that 'The general adoption of specific governance structures may not be appropriate for all firms. Simply adding to the number of non-executive directors may in fact create inertia problems as they struggle to understand the various parts of the business, request information and slow the decision making process' (Laing and Weir, 1999:463). Warren (1966) argues that in situations '... where new persons are continually coming or where important social differences exist in a setting, the sense of solidarity and shared consensus is difficult to develop or maintain' (1966:447). Feldman (1981) emphasises the need to understand the process of socialisation when a person is coming to terms in a new environment. Obst and White (2005) point out mere physical existence does not mean somebody is getting adapted to a particular framework of living but the development of an attachment is required which they say it as getting the membership of a 'Psychological sense of community' (2005:127).

In the above context, the arguments of Roberts, McNulty and Stiles (2005) explained elsewhere earlier is debatable. Findings of Mace (1971) suggest that the questioning of the CEO by the NEDs at the board meeting especially in front of the subordinates makes the CEO uncomfortable. When such situations occur, executive directors tell the NEDs, outside the board meeting that there are ways of asking questions from the CEO and *corporate manners* to be respected at board meetings such as to respect the

CEO. Stiles and Taylor (2001) argue the need to meet the CEO outside the board meetings, i.e. along the *corridor*. Argument of Mace (1971) may be important only historically as the scenario of the BOD has changed with more participants such as some institutional investors playing their supervisory role apart from the pressure groups such as environmental bodies and professional bodies (Aguilera *et al.,* 2006) but may still be valid to a corporate sector which does not get or which get less attention by the financial media and other environmental groups, as in some developing countries (Vives, 2000).

Vafeas (1999) making a positive response to codes on corporate governance, points out a breakdown of the elements of the cost of a standing board committee. Accordingly, the cost consists of the fees payable for each meeting attended, extra bonus (paid by some firms) for the person who chairs the meeting, travel and accommodation expenses and opportunity cost of the insider executives in attending to the meetings. All of these costs have to be borne by the shareholders. Financial Reporting Council (FRC, 2006a) lists the following costs to be borne by the listed companies to implement the key provisions discussed earlier in the Combined Code (FRC, 2006). They are: (1) fees for the new NEDs; (2) costs for tailored induction for new directors; (3) cost for the continuation of the directors' skills and knowledge; (4) performance evaluation of the board; (5) additional company secretarial resources and (6) insurance cover. Institutional investors too will have to incur some costs in the evaluation of the implementation of the provisions in the Combined Code (FRC, 2006). Hart (1995) points out that the maintenance of a chair for a corporation is costly.

Zhang (2007) points out that the PLCs have to meet a significant cost in the implementation of the rules of the Sarbanes-Oxley Act 2002. Author argues that some firms are de-motivated to seek equity capital. However, Leuz (2007) argues that there is no conclusive agreement on this aspect but a growing body of research. Sarbanes-Oxley Act 2002 forbids accounting firms in doing internal services such as project appraisal, internal system design and implementation while being engaged in auditing service to the same firm. This would ensure transparency and accountability.

Grant (2004) finds that compliance for Sarbanes-Oxley Act 2002 has been made necessary by many organisations and professional bodies such as commercial banks who lend money and legal firms who provide legal advice for the PLCs. Among the negative impact is the lack of willingness of the private companies to seek listing and attempts of some PLCs to pursue leveraged buy outs to return to private status (Dalton and Dalton, 2005). These authors signal of possible macro economic effects. This will not be a welcoming situation for the US as the growth of PLCs in the US was a sign of economic prosperity and was seen as a result of an *achieving society* (McClelland, 1962; 1975).

Grant (2003) points out the willingness of many BOD members to retire from the boardroom with the growing regulatory environment and criticisms of the directors in the corporate sector in the US. Miwa and Ramseyer (2005) point out a dilemma faced by PLCs that 'A New York Stock Exchange (NYSE) listed firm without outside directors is a firm begging for a shareholder suit, bad governance or good' (Miwa and Ramseyer, 2005:301). Kesner and Johnson (1990) point out that whatever the credentials of the NEDs are, the wrong doings of the insider directors affect ultimately

for the NEDs also as the BOD has a collective responsibility and as such the NEDs also face shareholder suits.

However, in the context of the opportunistic behaviour of the managers, which lead to corporate corruption, and possible loss of employment and tax burden in the event of failures of large corporations discussed above, there are benefits of the implementation of codes of corporate governance. Mace (1971) pointed out that the mere presence of the NEDs even is important as the CEO and other executive directors could be made vigilant over their responsibilities. As such, an attempt to see the gains of NEDs purely by arithmetic terms may not be advisable. Higgs (2003) points out that NEDs are in a position to make an objective assessment and to bring an outsiders' view to the strategy with their skills. Useem (2003) points out the need of corporate governance although there is a cost to be borne. Efficient and effective NEDs could guide an organisation to reach its objectives successfully (Wilkins and Ouchi, 1983; Pearson, 1987).

Taylor (2004) argues that the monitoring of the managers could be at the expense of the attention for the strategic development of the corporation. There could be 'over emphasis' (Weir and Laing, 2001:93) on the compliance of the NEDs to the monitoring of managers. Therefore, Taylor (2004) suggests looking at the role of the BOD again. 'A reappraisal of the board's proper role might suggest that they should give more time to assessing the company's competitive situation and building a strong position in the market. … a recognition of the importance of strategic direction and entrepreneurship' (Taylor, 2004:424). Strategic advice of the NEDs is pointed out by the Higgs review (Higgs, 2003) as the first among many other tasks. Competitive

position of a firm depends on the future course of action and development of entrepreneurship in the firm (Bhide, 1994) and with a need for achievement to seize the opportunities in the market (McClelland, 1962; 1975). If the strategic role is not given a significant time by the NEDs, CEO will be able to direct the corporations' strategy as he or she needs which would not be in the interests of the shareholders (Westphal, 1998).

The above discussion on the degree of implementation of the recommendations of the codes on corporate governance in the UK with a comparison of the US experience attempted to see whether there is an ongoing debate on the efficacy of the self-regulations versus the statutory regulations. Next part will discuss a paradoxical development in the corporate governance arena, i.e. the acceptance of the codes of corporate governance by the corporate sector and the persistent corporate governance problems. As a result, we have a researchable problem or a 'Development puzzle' (Mason, 1996:15) on the role of NEDs.

2.14 Unresolved Corporate Governance Problems

Persistent corporate governance problems are explained over and over again (Dann and Harford, 2002; La Porta, De-Silanes and Shleifer, 2002; Leuz, Nanda and Wysocki, 2003; Luo, 2006; Chalmers; Das, 2006; Fleming and Zyglidopoulos, 2006; Klapper, Laeven and Rajan, 2006). In the context of corporate governance problems, the acceptance of codes on corporate governance is a 'paradoxical compliance' (MacDonald, Nail and Levy, 2004:81), because the expectation is to align the

interests of the shareholders and other stakeholders. Therefore, a number of questions arises which need answers. Why does it happen so? And how does it happen?

The first question needs to get answers by looking at whether there has been an identification of particular corporate governance problem in the UK when compared with the corporate scandals and corruption in the US, as raised by many authors (Demirag, Sudarsanam and Wright, 2000; Jones and Pollitt, 2003; Kirkbride and Letza, 2004; Šević, 2005). Social contract theory argues that a government elected by the people of a country gets a contract to serve them and accordingly, government has to take necessary actions to meet the expectations of the society. When there is a threat for the normal situation, a government comes under pressure from the social forces (McCormick, 1976). Corporate failures in the capital markets have been such a trigger to disrupt the *status quo* in the society as evidenced by the history (South Sea Bubble case – Chapman, 1986) as well as the recent corporate collapses discussed at the beginning. Compliance for certain expectations in the environment have to be met by the governments however they are difficult. Cialdini and Goldstein (2004:594) argue that 'Compliance situations are often burdened with the task of correctly comprehending, evaluating and responding to requests in a relatively short time and therefore lack the luxury of entirely deliberate and rational decision making'.

2.14.1 Influence of Social Forces on Corporate Behaviour

In the above context, our attention should focus on whether there is a social element which lead majority of PLCs within a short period of time to comply to accept the non-regulatory codes of corporate governance (Cadbury, 1992; FRC, 2003) in the UK

(Dahya, McConnell and Travlos, 2002; Spira and Bender, 2004; Pass, 2004) and other countries (Gregory and Simmelkjaer, 2002; Cromme, 2005). Anand (2005) explains that mandatory regulations could make the majority to comply although there could be few, who violate but face penalties, but when there is voluntary disclosure; number of forces could force the firms to align the interests of the managers with the shareholders and other stakeholders. Number of authors find the corporate governance mechanisms such as the appointment of NEDs and the separation of chair and the CEO result in increased disclosures (Chen and Jaggi, 2000; Ho and Wong, 2001; Bushman, Piotroski and Smith, 2004; Barako, Hancock and Izan, 2006)[18].

Social psychologists explain the ways in which people's attitudes, values, and behaviours are acquired, organised, and changed through social interaction, social influence, and the social construction of knowledge (Pennington, 2000). Gibson (1966) explains that organisational man is a social and political animal and the behaviour is conditioned by the social norms and values in the organisation. Social identification theory (Obst and White, 2005) argue that the members of a society whether known or unknown to each other build up a 'Psychological sense of community' (2005:127) in which the foundation is the acceptance of the social norms and values. In such a community, a little request to comply for something could lead to a large compliance (Scott, 1977). Structures and processes build up to accommodate and pull individuals into line with the beliefs and practices of the society. If there is a deviant behaviour, punishments are inevitable and the rewards are offered for the obedient members across all the structured organisations, to name a

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[18] Combined Code (FRC, 2006: Schedule C) explains the required contents in disclosures such as the decisions taken at the board, details of the chair and other high officials, number of meetings, work of the committees of the board, etc.).

few, such as the armed forces, educational institutions, religious places and in business organisations (Sonnenfeld, 1985).

Apart from the structured acceptance of the norms and values, Bowles and Gintis (2002) argue that informal build up of social norms stand up to avoid threats which affect the stability and the orderly conduct of a community. Bothner (2003:1180) argues that 'When a social actor's rivals have adopted an advantageous trait, that actor is then likely to adopt it in order to avert the probable social and economic costs of falling behind'. Feldman (1984) points out that there are 'Informal rules adopt to regularize group members' behaviour' (1984:47). PLCs operate to achieve not only the individual corporate objectives but also to protect common interests of them, especially when there are threats to change the existing structures such as statutory and non-statutory rules and regulations which affect PLCs (Davis, 1991: Ornstein, 1984). The top management team explained as *organisational men* by Gibson (1966), such as the BOD and CEOs who are the *elites* in top management (Pettigrew, 1992) are influential in maintaining a certain framework of social norms in the business society (Mizruchi, 1983).

Organisational men mentioned above strengthen their ties through professional associations too. Professional associations have a collective behaviour in the society with a '… a benign moral or cultural code' (Dent and Whitehead, 2002:1). Romal and Hibschweiler (2004) find the accountancy profession worldwide is criticised for failing to address earnings management of PLCs. The *Sarbanes-Oxley Act 2002* is an unprecedented legislation which curtailed the activities of the accountancy profession which shows that the professional accounting bodies in the US have failed to live up

to the social expectations. Medical profession is required to ensure regular development of their standards than few decades ago due to the social pressure of demanding greater patient care and attention (White, 2004).

Thus, the social forces in a country influence not only the behaviour of the rulers or the politicians of a country but also the suppliers of capital, labour and management and also influence the designing of the corporate governance mechanisms of firms (Aguilera and Jackson, 2003). Aguilera *et al.*, (2006:148) write that 'Firms are situated within a given society and political tradition, which will influence the decisions of individuals within the firm'. When the PLCs operate globally, the factors which influence the corporate decisions are more complex and wide due to the environmental differences around the countries, that is social, legal, economic and political (Luo, 2005a; 2005b).

Whether the corporation does it business domestically or internationally, the influence of external pressure groups on corporate social behaviour is increasing (D'Aveni and Kesner, 1993; Tilt, 1994; Nel *et al.*, 1996; Davis and Greve, 1997; Weaver, Trevino and Cochran, 1999; Lewis, 2006). Quazi (2003) points out that corporations are represented by the people and therefore, corporate social commitments are maintained and advanced by the people who manage them. Presthus (1958) argues:

'Organizational behaviour is the product of interaction among the whole culture, a given organization and an individual personality which itself is the result of the genetic composition and unique experience of any given individual. In this context, an organization may be viewed as a miniature of society in which traditional social controls over the individual appear in sharp focus. The organization draws upon the accumulated learning and experience of the individual, who brings to it certain inculcated attitudes' (Presthus, 1958:49).

Soeters (1986) points out that the *excellent companie*s (Peter and Waterman, 1982) had a behavior similar to the norms and values of cults in the US existed during 1980s. In cults, there is a certain belief about the world and life with a strong leadership and devoted set of followers who do not question the beliefs and the values other than sharing them with the fellow members (Stark and Bainbridge, 1980). The values and the beliefs bind them all together. Similarly, in the *excellent companies*, the employees were groomed to believe of certain values in business and each and everybody shared the same irrespective of the position of the firm (Soeters, 1986). Thus, a bias for action and flexible decision making with an orientation to share the gains and losses without making any undue biasness helped these companies to emerge in the market as excellent companies. Similarly, Japanese management practices are laid upon on a set of values and beliefs between the employer and the employee protecting the survival of both, the firm and the employee when compared with the western managerial practice, which is individualistic (Naylor, 2000; Hofstede and Hofstede, 2005).

The influence of the organisations on the lives of people makes them live in an 'organisational society' (Morgan, 1997:120) as evidenced by the way people behave from morning to evening and also the way the behaviour is conditioned and programmed from birth to death of people[19]. Any organisation which fulfils the needs of the society as Drucker (1994:13) points out '… is a creation of the needs of the society'. Warren (2003:163) points out that 'It is important to realise that the company is a public institution and not just a private arrangement created by contract; it cannot,

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[19] In order to prepare the vital statistics and life expectancy tables, it is mandatory to record many events in life of a human being such as birth, marriage, divorce and death.

therefore, be fully determined by economic factors alone, but, is importantly, also partly determined by political and social factors'.

Therefore, comparison among the social units and evaluation of self against others by *organisational men* (Gibson, 1966) is a natural phenomenon (Scott, 1987; Suls, Martin and Wheeler, 2002; Shackleton, 2005). Hong, Kubik and Stein (2004) find that the transactions of stocks in the stock exchange by shareholders are influenced by the decisions of peer groups. The tendency to maintain and build relations is high given the right context. Grossetti (2005) argues that the social relations are created among people when they have close interests and arise '… out of certain contexts' (2005:297), but rarely on '… chance meetings' (2005:291). Cialdini and Goldstein (2004:598) argue that 'Humans are frequently motivated to create and maintain social relationships with others… If we engage in behaviours of which others approve, others will approve of us too. Accordingly, we use approval and liking cues to help build, maintain, and intimacy of our relationships with others'.

Researchers too benefit by their social networks. Andrew Pettigrew (Starkey, 2002) explains in an interview with the *European Management Journal* how personal networks have helped in his research on BOD. Starkey (2002) reproduces the narrative story of Andrew Pettigrew:

> 'Basically we used our own personal networks to start the process off. I knew two or three very senior and reputed figures in UK PLC's and I wrote and asked them if they would help us with the research. They were very interested in the aims of our work and agreed to write to ten key figures in UK boards that knew well and ask them if they would collaborate with our research project. These thirty letters [sic] produced a 100 % response rate' (Starkey, 2002:24).

Stiles and Taylor (2001) also have utilised their personal contacts in their research on BODs in the UK. They write (2001:26) 'The first approach was to begin, not be

direct approach by letter, but try to push on an open door through the use of a third-party contact. If successful, this would constitute a 'warm' contact and the interviewee could then recommend a subsequent interview with another director'. Authors point out that mutual gains solidify the relationships (Jensen and Greve, 2002) and lead to create strong social processes (Ryan, 1999).

Cialdini and Goldstein (2004:595) argue that 'Individuals are frequently rewarded for behaving in accordance with the opinions, advice, and directives of authority figures'[20]. Ashforth and Gibbs (1990:178) explain that such influences lead to 'Coercive isomorphism' which means the acceptance of a certain pattern of behaviour under influence not willingly. In such situations, the CEOs as well as the NEDs could become 'Targets to overt conformity' (Quiamzade *et al.*, 2003:390). Cialdini and Goldstein (2004:593) argue that 'Individuals avoid or alleviate feelings of shame and fear via public compliance and guilty and pity via private compliance'. Stiles and Taylor (2001:109) argue that in some cases, executives would follow the plans of chief executives, but may do not agree with the plans in private but approve as they depend on the CEO for their own ambitions of rising to the top job. Even in the context of self-conscientiousness of the need to resist for external influences, Bothner (2003) argues that in order to avoid any damage on business, the compliance for a certain way of working in the business world could be expected. Neilson and Rao (1987:526) argue that 'People do not speak openly about information and ideas if this

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[20] Jones and Pollit (2003:2) identify '*Authorities* as government officials and ministers and regulatory bodies such as Bank of England and the London Stock Exchange'.

might harm their chances at achieving their objectives or if this validates their standards of personal development'.

Social influence affects the behaviour of managers. Burt (1987:339) argues that 'Managers with social contact networks … monitor information more effectively than it can be monitored bureaucratically'. Kadushin (2002:81) writes that 'Network activity is the natural, necessary and original human condition'. Managers have a collective informal behaviour due to the influence of the interlock directorates as Davis (1991) points out. '…corporate action is not determined by solely by the characteristics of the organization as a social atom but also by the actions and characteristics of other organizations in its environment' (Davis, 1991:591). Jensen (1993) argues that by nature organisations do not wish external control systems. Langley *et al.*, (1995:261) point out that 'Decision making must be studied in *toto* and in *vivo* at the individual level to include insight and inspiration, emotion and memory, and at the collective level to include history, culture and context in the vast network of decision making that make up every organization'.

Ornstein (1984) investigating the interlocking directorships of more than 5,000 interlocks among the largest Canadian companies during the period of 1946 to 1977 argues that interlocking directorates serve to coordinate the political and ideological orientation of the capitalist society. This author argues that of these interlocks, 'Boards are viewed as vehicles that corporations use to control other corporations, to co-opt threats in their environment from competitors, suppliers, customers, and regulatory agencies; and generally to coordinate their business activities with other corporations' (Ornestein, 1984:210). Davis and Greve (1997) argue that network

structures are a key decisive force on the speed of spreading the governance practices and expose a firm to a particular role model. D'Aveni and Kesner (1993:123) argue that 'Cooperation and resistance may be a function of the social networks and power relationships that exists between and within firms'. Bothner (2003) points out that inter firm influence is greatest on firms facing the most competitive forces.

In order to stand for the common needs and to maintain social legitimacy, companies are keen to maintain public relations (Belkaoui and Karpik, 1989; Weir and Laing, 2001). Public relations through social interactions (Menon and Williams, 1994) help the companies to fall in line with the 'societal values' (Monks and Minow, 2004:531). When a company does business respecting the societal and ethical values of a society apart from the legal compliance (Jones and Goldberg, 1982; Goodpaster, 1991; Hill, Stephens and Smith, 2003), it gains social legitimacy (Suchman, 1995; Warren, 2003). Willkins and Ouchi (1983) point out that shared values contribute for the organisational performance.

Menon and Williams (1994) argue in falling in line with the above arguments of social influences and interactions that the formation of committees in the BOD is an attempt to show good governance to make the shareholders pleased. Weir and Laing (2001:93) question: 'Do companies regard complying with Cadbury as a public relations exercise?' Monks and Minow (2004) argue that the societal values (2004) make a significant impact in the development of corporate governance mechanisms in a corporation. Warren (2003:154) writes 'It is often assumed in discussions of the development of capitalist system that the pattern of change will follow a particular direction or route and that by and large all societies will eventually go down the same road'.

2.14.2 Opportunism in Acceptance of Corporate Governance

In the context of the social pressure and the need to make a legitimate existence in the corporate society discussed earlier, it is argued here that there is room for the opportunistic directors and the CEOs (Williamson, 1993: Chalmers, Dann and Harford, 2002; Das, 2006) to prepare an exaggerated *corporate governance report* in the PLC. Zerbe and Paulhus (1987) argue that the reporting of socially desirable events in the annual reports of companies is an impressionistic behaviour. Mizruchi (1983:427) points out that the BOD is 'A self-perpetuating oligarchy accountable to themselves'. Lack of shareholder activism (Stratling, 2003; Hodges, Macniven and Mellett, 2004; Birds, *et al.,* 2000*),* less than one hour of annual general meetings of all PLCs in one day such as in Japan (Vives, 2000), could leave the managers to do what they wish to do.

If the acceptance of corporate governance codes is purely in view of the needs of the investors other than the influence of the social forces it could lead to a high morale of the investor community. Investors would be in a position to get a better deal in terms of the availability of information for their investment decisions. Pagano, Panetta and Zingales (1998) point out that the private firms find it difficult to attract investors with an initial public offer due to lack of trust by investors. Legitimacy could be established by a PLC by getting the NEDs (Menon and Williams, 1994). It could be considered as an opportunity for the free rider investors (Stratling, 2003) to have more choices into their portfolio. Information is required for 'Informed decision making' (Monks and Minow, 2004:89) by the market participants and availability of information of the corporate sector suggests a good state of 'Financial transparency and governance transparency' (Bushman, Piotroski and Smith, 2004:207). Fama and

Jensen (1983a) argue that the shareholders are risk experts in diversifying the portfolio of investments but face a problem of adverse selection and moral hazard due to information asymmetry.

2.14.3 Firm Specific Factors

The above section argued that there is a possibility that the social forces surrounding the top management could influence the corporations to accept a common program of action through isomorphic behaviour and mimic behaviour. If there is no social influence on the CEO and the BOD, firm specific corporate governance mechanisms would be decided by path dependence, level of knowledge acquisition and contingencies and life cycle stage of a firm (Hermalin and Weisbach, 1988; Goodstein and Boeker, 1991; Bathala and Rao, 1995; Hart, 1998; Schmidt and Spindler, 2002; Aguilera and Jackson, 2003; Zahra and Filatotchev, 2004; Filatotchev, 2005; Miwa and Ramseyer, 2005; Williams, Fadil and Armstrong, 2005). Filatotchev (2005:26) argues that 'The development of 'one size fits all' corporate governance codes may be highly problematic for firms at different thresholds in their life cycle'. Pye and Camm (2003) too argue about the rationality of a particular model for all the companies. However, Finkelstein and D'Aveni (1994) argue that the duality is required when a firm needs to map out strong strategies and to implement them and to monitor by a single hand at crisis situations. However, these authors argue that when the firm has continuous success in the market, it is required to separate the office of chair and CEO. Unless the separation of office of chair and CEO is done, CEO becomes powerful with the good results and gets entrenched.

Some firms resort to the minimum legal requirements to practice corporate governance codes due to *switching costs* (Hart, 1995, Vafeas, 1999), path dependence (Schmidt and Spindler, 2002), and firm specific needs (Miwa and Ramseyer, 2005; Li, 1994; Lins and Lemmon, 2003). Laing and Weir (1999) point out that the time allocated for the NEDs is considered as a waste of time by some PLCs.

Development of corporate governance mechanisms is an evolutionary process since the young days of a corporation (Zahra and Filatotchev, 2004; Hart, 1995). Thus, the argument of path dependence and the evolution of firm specific corporate governance mechanisms are rational. Kole and Lehn (1997) point out in a study of the implications of deregulations in the US on the airline industry that the corporate governance structures evolve to suit the competition and the inability to make the changes in a firm lead to disappearance of the same from the market place. They write '… firms that survive in competitive markets are presumed to have optimal governance structures' (Kole and Lehn, 1997: 421). Li (1994) finds that the ownership structure, the degree of leverage, size of the firm, level of performance in the market and strategy of the firm decide the structural composition of the BOD. Williams, Fadil and Artmstrong (2005) argue that moderate size of the BOD has the ability of minimising illegal activities in organisations when they have complex structures and scattered markets.

2.14.4 NEDs and Their Behavioural Tendencies

Assuming that there are no social influences and opportunism of managers, if the NEDs attempt to maintain their reputation (Fama and Jensen, 1983a) as they work

under pressure due to growing criticism of their role in monitoring the managers (Byrd and Hickman, 1992; Dulewicz and Herbert, 2004; Helland and Sykuta, 2005; Jensen and Fuller, 2002; Miwa and Ramseyer, 2005), there could be a tendency for over emphasis to the codes of corporate governance which could result in imbalances in their fiduciary responsibilities (Davies, 2002). They would tend to give more weight to compliance rather than the strategic role (Ezzamel and Watson, 2000; Taylor, 2004). Maintenance of reputation of the NEDs as expert decision makers (Fama and Jensen, 1983a) enables them to get more directorships (Ferris, Jagannathan and Pritchard, 2003), more earnings (Yermack, 2004), and higher positions in the future career (Fich and Shivdasani, 2006). However, such developments of a NED could not be considered as useful sometimes as Baumeister and Exline (1999:1173) argue 'Prideful people may be so self focused that they are less prone to contribute to the group's welfare or to be willing to make sacrifices for others'.

Over emphasis of the NEDs would bring bad consequences too as the CEO and the executive management could rise against the NEDs if they loose the hitherto enjoyed privileges and power such as the appointment of the desired personnel they like and giving them promotions and maintaining perquisites such as luxurious offices (Berle and Means, 1933) and the higher compensation with many other perquisites (Bebchuk and Grinstein, 2005). Therefore, the excessive monitoring by NEDs could lead the CEO to many ways of attempting to reach the NEDs to get back power through impression management (Gardner and Martinko, 1988; Westphal, 1998). Pennington (2000) explains two broad techniques people use in impression management called self-enhancement and other-enhancement. Self-enhancement is easy to understand.

For example, a person going for a job interview attempts at best to make him or her pleasant to the management (Pennington, 2000). Executives would use other enhancement methods such as 'flattery' (Pennington 2000:68) and other methods such as the constant consultation of the directors and listening to them for corporate matters. Another way of influencing the BOD by the CEO is by the knowledge of the business gained as a result of being in the business world for years (Westphal, 1998). Hill and Phan (1991) argue that tenure of the CEO is a decisive factor for the ability of influencing the NEDs to approve business plans prepared by the CEO. According to these two authors, the CEO has the authority of the information system in the firm and the willingness to give information required by the NEDs rests upon the CEO.

Impression management tactics of the CEO towards the NEDs would result in recognition of the abilities of the CEO by the NEDs and in turn the CEO will be able to get approval for his plans among them the diversification of business and get entrenched more solidly (Walsh and Seward, 1990). Amihud and Lev (1981) point out that the managers are keen to diversify through mergers and takeovers because they have no any other way of diversifying their own risk of job survival. Zajac and Westphal (1996) in their research on the relationship of CEO and the BOD also agree with the above authors. They write '…by diversifying into unrelated businesses, managers can stabilize their investment portfolios while also reducing their employment risk' (Zajac and Westphal, 1996:513). Hermalin (2005) sees a trend of getting only the outsiders as CEOs in the future. In this context, it is reasonable that the managers have a tendency to protect their jobs because as Agrawal and Mandelker (1992) point out that they will not only lose their jobs but the lose of the job will result in a downward revaluation of their general human capital also.

Research has found that the CEO consults his or her top management for decision making (Mintzberg, 1983; Shackleton, 2005). Craven (2006:25) writes that 'CEO is surrounded with an extremely qualified and capable people'. Nel *et al.*, (1996:5) argue that 'Decision making is a process involving multiple actors, who participate in various ways at different points in the process. It is suggested that alternative roles can be assumed by different functional areas throughout the decision process and frequently the participation of several decision makers will be required'. Hambrick and Mason (1984) also agree with the above authors in writing 'Chief executive shares tasks and to some extent power with other team members' (1984:196). Drucker (1974) points out those large organisations face unstructured, complex and uncertain decision environments and therefore, it is difficult for a single person to take managerial responsibilities. Herbert (1976) argues: 'It is impossible for the behaviour of a single, isolated individual to reach higher degree of rationality. The number of alternatives he must explore is so great, the information he would need to evaluate them so vast that even an approximation to objective rationality is hard to conceive' (Herbert, 1976:79).

Katz and Kahn (1978) argue that a relationship built among colleagues centred on the CEO during a long-term period bind them all strong as a group. The charisma of the CEO results in creating favourable attributions among the followers because a successful CEO creates a 'Sense of mission, articulating a future oriented, inspirational vision' (Waldman, Javidan and Varella, 2004:358). Relationships lead to high level of cohesiveness and accordingly to take actions jointly (Mullins, 1999). They become effective work groups (Zaccaro and Dobbins, 1989) in terms of the abilities to create ideas (Paulus, 2000). Studies on group behaviour show that the

threats coming from the external environment could be challenged by the creativity of groups (West, 2002; Ornstein, 1984). The low turnover of executives is an indicator of work satisfaction (Angle and Perry, 1981). Effective groups build collective strong structures, which have shared values. Shared value frameworks result in creating a unique web of interactions with the systems, strategy, structure, staff, etc. as shown by the best run companies in the US[21] (Peter and Waterman, 1982). When such shared values exist in the corporation, there will be a tendency to build a pattern of norms for the individual behaviour among the members. The exchange of information, protection of the interests of the group, pattern of communication, etc. within the work place becomes informal among the groups close to each other. Shared values of the corporate executives determine the shape up of decisions and company culture (Reynolds, 1986; Mintzberg, 1983; Shackleton, 2005).

Executive directors depend on the CEO for their promotion and future career expectations (Borokhovich, Parrino and Trapani, 1996). Offer of outsider executive directorships to insider executives is mainly decided by the relational power of the executives to the CEO (Richardson, 1987). Executive directors get their power through their position and relationships with the CEO (Minszberg, 1983). Thus, the protection of the CEO from an emerging power will be considered as important by the executive directors. Unless it is done, all the privileges enjoyed by the long stay of executives in the company will be lost. In this context, it can be expected that the CEO is supported by the subordinates to face any threats in the environment including the regulatory bodies. Therefore, the NEDs could be considered by them as a threat

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[21] Few of these best run companies later on had problems, which resulted in downsizing. Thusman and Oreilly (1996) explain the reasons of such collapses of well-established companies.

for their usual way of doing decisions in strategy formulation and day-to-day operations.

Managerial behaviour explained above could cripple the corporate governance mechanisms (Walsh and Seward, 1990). In the long run, in the context of polarisation of relations between the NEDs and the executive management due to the widened information asymmetry, lack of strategic thinking and faulty attributions for success and failure by both the BOD and the management (Sundaramurthy and Lewis, 2003; Hillman and Dalziel, 2003). The corporation would not be competitive in the market and eventually would collapse (Thusman and Oreilly, 1996). These authors equal this phase of the organisation as development of *organisational cholesterol*. If the working relationship of the management and the BOD is good, it will create a situation to get the best possible corporate governance mechanisms (Westphall, 1999). Stewardship theory of corporate governance believes that the managers are conscious to protect the assets of the shareholders (Davis, Schoorman and Donaldson, 1997). They must be encouraged and the BOD is therefore not in the control mood of the managers but support them.

Sundaramurthy and Lewis (2003) argue that too close relationship between the management and the BOD is not good for the long run well being of the corporation because they would tend to be cohesive. When the management and the BOD have too close relationships, they are unable to see the future world and to change the present systems but blame the environment for the problems facing the corporation. Kadushin (2002:83) argues that 'Persons embedded in a dense cohesive network all have the same information, each is constrained by the other, but at the same time one cannot be played

off against the other'. Many authors point out the need to pay serious attention for the scanning of the environment, probing the assumptions, right perception and right attributions for the success and the failure of the firm (Forbes and Milliken, 1999; Rindova, 1999; Hillman and Dalziel, 2003; Roberts, McNulty and Stiles, 2005; Haleblian and Rajagopalan, 2006). Unless the top management including the BOD and the CEO and other senior management have the correct diagnosis of the problems and are not honest but have faulty attributions for the corporate failure or the success, they would not be able to see the needed changes in the strategy.

2.15 Conclusion

Literature review has identified the contribution of many authors for the development of the debate on corporate governance. However, the review identified many of the strong areas in the literature namely the documentation of the corporate governance problems, mainly in the developed capital markets, namely the US and the UK and the designing of the corporate governance mechanisms both internal and external. However, there is still to understand why and how the corporate governance problems occur despite the implementation of both statutory and non-statutory Codes on Corporate Governance.

When compared with the papers which document the corporate governance problems, an insignificant proportion of discussion could be seen in relation to many aspects of corporate governance both in the developed capital markets and emerging markets. Among them are: (1) the evolution of corporate governance mechanisms; (2) the interplay of internal and external corporate governance mechanisms; (3) the need to

look at the role of the NEDs through many perspectives, not only through the interests of the shareholders but through other stakeholders and (4) measurement of the contribution of the NEDs through the interests of many stakeholders. Above all of these, literature review identified the need to look at the role of the NEDs in the context of the emphasis on the implementation of the non-regulatory Codes on Corporate Governance. Theory argues that there should be a good understanding among the NEDs and the executive directors with right perception, attributions, attitudes and shared responsibilities.

Analysis into the methodologies and methods of research into the role of NEDs show (Chapter 4) that the authors have used number of research methods such as simple regression analysis based on archival data to see the demographic attributes of the BOD with the performance of the firm, interviews with the CEOs and members of BOD and observations of the boardroom too (Samra-Fredericks (2000a; 2000b). Interviews with the members of the BOD and observations are difficult research methods due to the difficulty of securing opportunities (Pettigrew, 1992; O'Higgins, 2002, Kakabadse, Kakabadse and Barratt, 2005). Simultaneously, the significance of the cognitive aspects of the top management and the BOD rather than the individual demographic factors and the institutional factors in corporate governance has been identified (Forbes and Milliken, 1999; Rindova, 1999; Haleblian and Rajagopalan, 2006).

The researcher believes that the aim and the objective set for this chapter is achievable with the above discussion on the general theoretical framework on corporate governance. Therefore, in the context of understanding of the regulatory and non-

regulatory environment in corporate governance, the next chapter would venture to discuss the institutional framework of corporate governance in Sri Lanka. Many authors (Shleifer and Vishny, 1997; Goodwin and Seow, 2002, Monks and Minow, 2004) point out the lack of understanding of corporate governance issues in the developing countries although some authors focus on various aspects of corporate governance in developing countries such as law and effectiveness of law (La Porta *et al.*, 1998; Bhattacharya and Daouk, 2002). The understanding we could get of the institutional framework on corporate governance in Sri Lanka coupled with the knowledge we have so far got from this chapter would direct us to develop the research instruments and design research methodology, which will be the discussion in chapter 4.

Chapter III

Regulatory Framework of Corporate Governance in Sri Lanka

3.1 Introduction

In Chapter 2, the main role of the statutory and non-regulatory codes on corporate governance was identified as the protection of the interests of the shareholders and other stakeholders. Both statutory regulations such as the Companies Act, 2006, UK and non-regulatory codes such as Cadbury (1992) and Combined Code (FRC, 2006) influence corporate governance interactively. For example, sections 173 of Companies Act (2006), explains the duty to exercise independent judgement by the directors while the Combined Code (FRC, 2006) explains how the independence of a director could be achieved. Companies Act (2006) does not specifically mention about independence.

With the theoretical knowledge gained from Chapter 2, this chapter discusses the corporate governance framework in Sri Lanka applicable to the listed companies with the view of identifying how the interests of the shareholders and the other stakeholders are protected. We find a large number of regulations in Sri Lanka equally applicable for the listed and non-listed firms and covering a wide array of subjects. A few of them are: (1) regulations relating to the working hours and holiday entitlement (Shop and Office Employers Act, No. 44 of 1985); (2) regulation of public utilities in relation to the issue of licenses to operate, regulation of tariff, technical and other standards (Public Utilities Commission Act of Sri Lanka, No. 35 of 2002) and consumer protection from monopolies, mergers and anti-competitive practices (Fair Trading Commission (Amendment) Act No. 57 of 1993). However, our discussion would be

limited to the main regulations affecting the listed firms and restrict to see how they protect the interests of the shareholders and the other stakeholders.

Among the regulatory framework, most recently approved Companies Act, No. 7 2007[1] of Sri Lanka, is applicable for public quoted companies. This new act repeals Companies Act of 1982[2] of Sri Lanka. The observation of the regulatory framework discussed below shows that since mid 1980s, the regulations have increased but not in a vacuum. The growth of the corporate sector could be the corner stone other than the international factors such as the regulations of the Basle Accord on the commercial banks and acceptance of international accounting and auditing standards. In overall, the growth of the regulatory framework could be positioned in the context of the growth of the corporate sector which is discussed in the chapter later with the data.

Unlike in the UK, where there is a single regulator, that is Financial Service Authority (FSA, 2006), in Sri Lanka there are a number of regulators operating independently, that is Registrar of Companies, Institute of Chartered Accountants of Sri Lanka (ICASL), Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB) and the Security Exchange Commission (SEC), to name a few. As a result, multi-regulation of the listed firms could be seen. For example, commercial banks are regulated by the Central Bank of Sri Lanka (CBSL) along with the ICASL, SLAASMB and the Registrar of Companies. In order to understand this scenario, this chapter covers few significant sectors in the economy which have a significant contribution for the national economy (Central Bank of Sri Lanka, 2006).

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[1] Downloadable from: http://www.drc.gov.lk/App/ComReg.nsf/Act?OpenPage

[2] Downloadable from: http://www.drc.gov.lk/App/ComReg.nsf/Act?OpenPage

Non-regulatory environment in Sri Lanka is at infant stage at present (IOD, 2005[3]; Chandrakumara and Budhwar, 2005). Only very recently, in 2006, ICASL and the SEC have drafted a Code on Corporate Governance to get the views from the listed firms and other participants in the Colombo Stock Exchange[4]. However, our discussion would be limited to understand the nature of the present regulatory framework.

3.2 Regulatory Framework

Among the statutory regulations, the Companies Act, No. 7 of Sri Lanka, the Securities Council Act, No. 18 of 2003 and the Sri Lanka Accounting and Auditing Standards Act No.15 of 1995 are most significant (Samarakoon, 1999; Chandrakumara and Budhwar, 2005). Apart from these, there are specific acts for certain sectors in the economy such as the finance industry (banks, finance companies and insurance mainly) along with general business law applicable for all type of business firms. These also will be discussed in brief. To how far the legal framework is effective is also required the attention and the findings in the literature relating to the country would be discussed later in the chapter.

3.2.1 Company Law

In relation to the new Companies Act, No. 7 of Sri Lanka, our discussion is restricted to see some of the major features which protect the interests of the shareholders, directors and the managers. Section 183 of the Act specifies that the Registrar of Companies in Sri Lanka shall have the power to verify the assets and liabilities of any

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[3] This publication covers the corporate governance experience in several countries including Sri Lanka.

[4] Downloadable from: http://www.ecgi.org/codes/documents/sri_lanka_draftcode_july2006.pdf

company. Section 184(a) of the above Act insists that the business and officers of a company shall be managed under the direction or supervision of the board of the company. Section 184(b) insists that the board of a company shall have all the powers necessary for managing and for directing and supervising the management of the business and affairs of the company.

The new Act protects the interests of the shareholders and the other stakeholders mainly the directors and the managers in many ways. Shareholders have wider powers which they did not have in the 1982 Company Act of Sri Lanka. Shareholders and co-directors can sue the directors if they fail to exercise due care and diligence in business judgement. However, the duties of the directors are generally mentioned in the Companies Act No. 7 of 2007 in Sri Lanka as in the Companies Act of 2006 in the UK (section 171 to 177). These general functions are the due to serve the company within the powers, promotion of the business, exercise judgment and exercise reasonable care. The duties of the directors are not specifically mentioned giving the opportunity for the corporations to decide what type of tasks the directors have to take within these general duties.

The new Act gives power to the shareholders to initiate derivative suit actions. This is a new feature which was not available in the Company Act of 1982. Derivative law suits against the company is a right of the shareholders and the directors in many countries such as the US and the UK but in Sri Lanka, this right is coming into first time with the Companies Act of 2007 of Sri Lanka (sections 234 to 237). However, the court has the right to decide according to the above sections to proceed or to discontinue the proceedings. In the case of derivative suit actions, the company has to bear the cost of proceeding. At the same time, if the shareholders make false claims

and if it is proved by the management in the Commercial Court in the country, they could be made liable and could be prevented attending the subsequent shareholder meetings too.

The third significant development in the new Act is that the minority shareholders can ask the company to buy-back the shares if they think some actions or decisions of the company are not in their favour. Major transactions such as amalgamation with another company, reduction of share capital which could affect the debt equity balance, change of the name of the company and status of the company are such situations which could lead to buy-back situations (section 92(1) of the Companies Act of 2007). In such situations, the above Act gives power to the minority shareholders to ask the company to purchase the shares and the company has to oblige after meeting certain conditions. They are the decision on a fair and reasonable price and the time to express objections by any disaffected shareholders (section 95 of the Companies Act of 2007).

However, buy-out operations are not always in favour of the shareholders as explained in chapter 2. Buy-outs could be exploited by the companies to prevent take-overs from another company (Kosnik, 1987; Davis, 1991) and also by some managers to leveraged buy-outs (Shleifer and Vishny, 1997) crippling market forces emerging. However there are many advantages too: Buy-outs prevent the use of cash flow surplus for acquisitions (Amihud and Lev, 1981) and extravaganza life in the corporate offices (Berle and Means, 1933) too. However, the Companies Act of 2007 has many checks and balances in the process of the buy-backs and one of them is to see the source of financing the buy-backs. These actions should not contravene the rights of the shareholders (section 99) and there is a need to get a special resolution passed by the shareholders at an extraordinary meeting.

Directors are required to meet several criteria in relation to the appointment into the BOD of a PLC in the new Companies Act, 2007 of Sri Lanka[5]. They are: the upper age limits, declaration of the qualifications, declaration of the interest of the directors, re-election, removal, remuneration and restrictions on loans to directors. These criteria could be useful to the shareholders and other stakeholders to see that the directors have behaviour acceptable to them. Some of the decisions of the directors of the companies such as the amalgamation, winding up and compromises with creditors require special approval of the shareholders at an extraordinary shareholder meeting as well as the approval. However, the directors have the right to take indemnity and insurance cover according to the new act. This shows evidence to suggest that the liability of the directors is minimised in Sri Lanka too as found in many countries by Cheffins and Black (2006).

Legal provisions relating to insolvency laws in the country are an area to be developed further (Batra, 2006). In the new Act, there is special attention for the issues arising out of winding up of a company due to bankruptcy (section 270 to 284 of the new Act). Accordingly, in order to protect the interests of the shareholders as well as the creditors, the new Act has paid attention for the appointment of the liquidator and administrator to be fair for all the stakeholders.

The Companies Act, 2007 of Sri Lanka pays attention for the various tasks at the formative stage of the companies, namely, preparation of the documents necessary for incorporation, preliminary expenses and how the company intends to consider them as initial cost, justification for the expenses and accounting records to be kept are among

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[5] There was no special provision in the Companies Act of No 17, 1982 of Sri Lanka in this regard.

many of these. Therefore, by looking at these aspects, it could be argued that the new Act has many regulations to protect the interests of the shareholders and the other stakeholders.

3.2.2 Role of Security and Exchange Commission (SEC)

In chapter 2, number of prerequisites was identified as necessary for the development of the capital market, among them mainly the legal environment and the effectiveness of the law (Chapman, 1986; Irvine, 2001; Cheffins, 2003). While the Companies Act, No. 7 of 2007 provides the regulations necessary for the protection of the interests of the shareholders and other stakeholders such as the debtors, the SEC (established by the Securities Council Act No. 36 of 1987) is given power to regulate the conduct of the security market in Sri Lanka. The SEC is the sole authority which can issue license to operate a stock exchange, appointment of stock brokers and dealers. In order to regulate the growing number of institutions in the financial industry in Sri Lanka since early 1980s such as the Unit Trusts, credit rating agencies and underwriters, the Securities Council Act No. 36 of 1987 has been revised in 1991 and in 2003 with the new Securities Council Act, No. 18 of 2003. Objects of the SEC are:

(a) The creation and maintenance of a market in which securities can be issued and traded in an orderly manner;

(b) The protection of the interests of investors;

(c) The operation of a Compensation Fund to protect investors from financial loss arising as a result of any licensed stock broker or licensed stock dealer being found of not meeting his contractual obligations; and

(d) The regulation of the securities market and to ensure that professional standards are maintained in such market.

Among the investor protection activities of the SEC, ensuring the compliance of the firms to the regulations and prevention of insider trading activities rank high (SEC, 2006). Listed companies are required to submit the annual reports within a six months period of the close of the financial year and SEC pays attention for the disclosure level and the quality of financial and non financial information. Later in this chapter, the effectiveness of these will be discussed with examples from the annual report of the SEC (SEC, 2006) and the literature.

3.2.3 Accounting and Auditing Standards

Among the corporate governance problems identified in chapter 2 are the accounting and auditing frauds, discussed as problems of earnings management (Healy and Wahlen, 1999; Leuz, Nanada and Wysocki, 2003; Davidson, Stewart and Kent, 2005). Designing the Accounting and Auditing standards, implementation and monitoring of the practice among the firms is a vital aspect in preventing earnings management. ICASL is responsible for the adoption of the accounting and auditing standards. ICASL is a member of the International Accounting Standards Committee (IASC) as well as the International Standards of International Auditing Practices Committee (IAPC). SLAASMB which has been set up under the Sri Lanka Accounting and Auditing Standards Act No. 15 of 1995 has the oversight power of the implementation of the above standards.

The above Act has defined certain enterprises as Specified Business Enterprises. These enterprises are required to prepare, present, and audit financial statements according to the Accounting and Auditing Standards enforced by the ICASL (IOD, 2005). The above Act imposes certain duties and obligations on specified business enterprises and their directors, officers and auditors. If they are found in default, it would result in

various penalties, extending up to an imprisonment of responsible company officials for a term of 5 years (IOD, 2005).

These Specified Business Enterprises are: (1) companies licensed under the Banking Act, No. 30 of 1988; (2) companies authorised under the Control of Insurance Act, No. 25 of 1962, to carry on insurance business; (3) companies carrying on leasing business; (4) factoring companies; (5) companies registered under the Finance Companies Act, No. 78 of 1988 and (6) companies licensed under the Securities and Exchange Commission Act, No. 36 of 1987, to operate unit trusts, fund management companies, and registered as stockbrokers or stock dealers, or as a stock exchange (IOD, 2005). There are number of other companies registered under this act: (1) companies which have a turnover in excess of Rupees 500 million[6]; (2) companies which at the end of the previous financial year, had shareholders equity in excess of Rupees 100 million; (3) which at the end of the previous financial year had gross assets in excess of Rupees 300 million; (4) companies which at the end of the previous year had liabilities to banks and other financial institutions in excess of Rupees 100 million and (5) companies which have a staff in excess of 1,000 employees. In addition to these, public corporations (state enterprises) engaged in the sale of goods or the provision of services and a group of companies, any one of which fall within any of the above categories also are required to adhere to the accounting and auditing standards.

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[6] The average annual exchange rate between Sri Lanka rupee and sterling pound was Rupees 191.5 for one Sterling pound in 2006. For 11 months from Jan to Nov, 2007, the average Forex rate was Sri Lanka Rupees 221.5 for one Sterling pound. See: http://www.cbsl.gov.lk/pics_n_docs/_cei/_docs/er/Monthly%20Average%20Exchange%20Rates.xls

All the above enterprises are required to prepare financial statements in compliance with the Sri Lanka Accounting Standards and also required to audit the same with the Auditing standards. SLAASMB is required to see the compliance by the directors and the managers. Auditors also are required to take the responsibility for the above task. Financial statements are required to be submitted to the SLAASMB. Sri Lanka has implemented International Accounting and Auditing Standards[7]. Web site[8] of the SLAASMB lists several significant cases of failure to adhere the rules relevant to accounting and audit standards and the actions taken for them. Some of them are: (1) the failure of *Alliance Finance Company Limited* and *Central Finance Company Limited,* to disclose the diminution in value of shares in two companies held as investment securities in its financial statements for the year ended 2000; (2) non-declaration of depreciation in respect of furniture, fittings and equipment by *Asian Hotels Corporation Limited;* (3) over statement of liability on account of taxation by *Ceylinco Insurance Company Limited* and (4) non-making of provisions for temporary decline in value of investments in subsidiaries of *Kapiala Heavy Equipments Limited.* Altogether, there are 13 instances of failure to maintain the accounting and auditing rules.[9]

3.2.4 Regulation of BODs of Listed Firms in the Financial Industry

Registrar of Companies in Sri Lanka has the statutory power of verification of the assets and liabilities of listed firms irrespective of the nature of the business. The Monetary Law Act No. 32 of 2002, Sri Lanka insists that the CBSL has the power to

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[7] See: http://www.slaasmb.org/IAS%20AND%20SLAS.html

[8] See: http://www.slaasmb.org/significant_cases_detected1.htm

[9] See: http://www.slaasmb.org/significant_cases_detected1.htm

verify the assets and liabilities and general business activities of some types of financial firms (commercial banks, finance companies, licensed specialised banks)[10]. Some ventures in the financial industry has their own acts of incorporation such as pension funds, provident funds, insurance companies and long term credit institutions (Central Bank of Sri Lanka, 2006).

Therefore, the BODs of the listed firms which belong to the financial sector come under twin control. Supply of monthly information to both regulators are required according to the above Acts but in different formats. For example, the commercial banks are required to abide by the capital adequacy regulations[11] (Basle Accord) of the International Bank for Settlements and the CBSL is the country supervisor to see the implementation of the capital adequacy regulations in the country.

The BODs of the long term credit institutions in the country (Development Finance Corporation of Ceylon, National Development Bank, State Mortgage and Investment Bank, Housing Development Corporation of Sri Lanka), come under the respective act of incorporation. These institutions are controlled by the funding institutions too, mainly, the International Finance Corporation and the Asian Development Bank (World Bank, 2007). However, in the case of these institutions which were established by the Acts of the Parliament, the ultimate power rests with the Parliament. Despite the ownership of shareholders both public and institutional, they have no special power to

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[10] In the UK, all the financial firms such as banks, mortgage and leasing companies, insurance etc. come under the unified authority i.e. Financial Services Authority (FSA, 2006).

[11] The Total Risk Weighted Capital Adequacy Ratio, required to maintain by commercial banks in Sri Lanka is 10 per cent at minimum, with the core capital (Tier 1) constituting a 5 per cent minimum. Tier 2 could constitute the supplementary debt capital (Central Bank of Sri Lanka, 2006: See Chapter 8).

control or to appoint the BOD of these institutions. This is a special situation in relation to the shareholder interests (World Bank, 2007).

Among other PLCs in the financial industry, finance companies, insurance companies, mutual funds and unit trusts play a significant part in the economy (Central Bank of Sri Lanka, 2006). Finance companies are required to get registered under the Finance Companies Act, No 78 of 1988. Before 1988, finance companies were regulated with the Control of Finance Companies Act No 27 of 1979 but it was 'Insufficient to effectively supervise and regulate finance companies' (Central Bank of Sri Lanka, 2004:25). The BODs of many of the failed finance companies were responsible for the mismanagement of portfolio, corruption and lack of skills both management and portfolio mix resulting a huge loss for the depositors and the tax payers (Central Bank of Sri Lanka, 2004). Of the 72 finance companies, which were operating before the enactment of the Finance Companies Act, No 78 of 1988, only 25 were able to register under the new Act (Central Bank of Sri Lanka, 2004).

In order to operate a finance company in Sri Lanka, Finance Companies Act, No 78 of 1988 emphasises the need to meet the following criteria: (1) minimum amount of capital required to be maintained; (2) maximum amount of share, an individual could have in the issued capital; (3) personal responsibility of the directors for the operations, and (4) submission of periodical reports to the CBSL. As a result of these strict regulations of above, confidence of the general public was restored in the finance companies as evidently shown in the growth of the finance companies in the later years (Central Bank of Sri Lanka, 2004).

BODs of the Unit Trusts are regulated by the SEC with a special regulation under the section 52 of the Securities Council Act No. 36 of 1987. Accordingly, the unit trusts have to take a licence from the SEC to operate. They must give the investment plan at the time of registration and subsequent reporting of the business operations is also required. In 1995, SEC has issued a Code of Operation for the Unit Trusts. Accordingly, the duties of the directors, trustee and management company are mentioned in this code which is issued as a rule under the section 53 of the SEC Act. Unit Trusts have their own association called Unit Trust Association which functions as a self regulatory body for the discipline of the members as well as for liaison with the authorities.

The insurance industry is one of the highly regulated sectors in the country. Regulation of Insurance Industry Act, No. 30 of 2000 has created the Insurance Board of Sri Lanka (IBSL). To operate insurance business in Sri Lanka, companies are required to get a licence from the IBSL (in addition to the incorporation complying the Companies Act, No. 7 of 2007), and are subject to regulations and supervision of the IBSL. IBSL has issued a draft in 2006 for the discussion among the participants in the industry. The aims of the draft are:

> 'The guidelines, which cover a wide spectrum of the operations and administration of linked long term business, aim to facilitate the orderly development of linked long term business with prudential standards of corporate governance and also to maintain and improve the professionalism of insures and their intermediaries and sales of linked long term business, thereby ensuring fair treatment of policy holders' (IBSL, 2006:1)[12].

Insurance industry has not only statutory regulations but also self regulations in the form of guidelines for better service for the customers. Insurance Ombudsman[13] is the

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[12] See http://www.ibsl.gov.lk/public_consultation/1_Guidelines_on_linked_long_term_business.pdf

[13] See http: //www. insuranceombudsman.lk

non-regulatory body which has power to inquire into and settle any complaints and disputes between individual customers and the insurance institutions.

In order to protect the public interests from monopolies, mergers and anti-competitive practices, Government of Sri Lanka has enacted the Fair Trading Commission in 1987 under the Act of No. 1 of 1987. Section 11 of the Act specifies that a complaint of an existence of monopoly, merger or anti-competition in the business sector will get the attention of the Commission to look whether any of the above or all is detrimental to the general public of the country. Accordingly, fixing the maximum price for a product or service while protecting the return on investments is a key task of this Commission. Institute of Policy Studies (2002) points out that the above Commission has investigated number of complaints of several listed companies in the last few years with some decisions to penalise and in some other cases to reject the claims. However, the lack of funds of this Commission prevents the proper administration of the tasks of the Commission according to the Institute of Policy Studies (2002).

The regulatory bodies mentioned above come under the examination of the Committee on Public Enterprises (COPE) established in 1979. The Committee consists of 19 Members of the Parliament reflecting the party composition in the House and is established under the Standing Order 126 at the beginning of each Parliamentary Session and the Chairman is elected by the Members of the Committee at its first session. The duty of the Committee is to report to Parliament on accounts examined, budgets and estimates, financial procedures, performance and management of Corporations and other Government Business Undertakings. Later in the chapter, when the effectiveness of the regulatory authorities is discussed, findings of the COPE are discussed in brief as they have a significant bearing on the interests of the investors and the capital market.

The above discussion reveals that the public sector companies in Sri Lanka comes under a number of statutory regulations. For example, the listed commercial banks come under the purview of the Shop and Office Employers Act, No. 44 of 1985; Fair Trading Commission Act of No. 1 of 1987; Banking Act of No. 30 of 1988, the Sri Lanka Accounting and Auditing Standards Act No.15 of 1995; Monetary Act, No. 32 of 2002, and Companies Act, No 7 of 2007. These are few to mention. Therefore, what we see is that the economic enterprises are heavily regulated and also the regulations are scattered across several institutions. This situation has been identified by Pierce and Waring (2004:333) who write: 'In Sri Lanka, there is a plethora of regulations in many forms'. However, the selection of a regulatory system is a decision of the society. Governor of the CBSL speaking on the regulatory system of the banking industry in Sri Lanka says that 'One needs to be practical and sensible in deciding the appropriate system for its financial services industry. The size of the country, the track record of supervisory authorities and more importantly, the close interaction between the supervisory authority and the institutions to be supervised, are important considerations'[14]. Choice of the system for a country is a decision of the prevailing social, political and economic environment and therefore, corporate governance system too is a result of this environment as we have seen in chapter 2.

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[14] See: http://apbsrilanka.org/special.html

'Address by Mr A S Jayawardena, Governor, Central Bank of Sri Lanka for the Association of Professional Bankers of Sri Lanka 14th Anniversary Convention, 2002, Colombo'.

3.3 Effectiveness of Regulations

Unlike in the UK where there is a Regulatory Impact Assessment (RIA) study for each piece of statutory and non-statutory legislation (see Regulatory Impact Assessment: Amendments to the Combined Code 2003), RIA studies on a regular basis have not been undertaken in Sri Lanka (Institute of Policy Studies, 2005). Therefore, the effectiveness of the regulations is discussed with the reports and literature available but it is difficult to see from a holistic view on the effectiveness due to the lack of studies.

Batra (2006) points out that the Registrar of Companies in Sri Lanka works under limited resources. Therefore, the Registrar of Companies faces difficulties to achieve the full implementation of the oversight responsibility especially to look into the state of compliance for the regulations on the submission of annual reports and the nature of disclosures. However, Batra (2006) praises the office of the Registrar of Companies while showing the difficulties faced by the Registrar in the execution of the duties. 'The office of the Registrar of Companies lacks the capacity to administer the official receivers and the liquidation process. They are not exposed to any education and training and are not schooled in best practices. However, their integrity and independence are not in doubt' (2006:14).

The Second Report[15] of the COPE contains observations and recommendations on the COPE examination on the performance and current affairs of the CBSL. It shows that the CBSL has failed to discharge its regulatory function in regard to the supervision of

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[15] This report has not been published to date and therefore, there is no way of seeing the original document other than relying on various press reports and writings of several journalists at the moment. Many attempts were made to secure a report but were not successful yet.
See: http://servesrilanka.blogspot.com/2007/09/cope-report-soon-to-be-released.html

some of the finance companies as well as to recover the loans given to recover the companies failed[16]. The report states that the CBSL has failed to discharge some of its supervisory duties illustrating the inability to recover the refinance facilities provided to 13 default finance companies during 1988 and 1994.

Bhattacharya and Daouk (2002) argue that insider trading laws are not effective in the emerging countries. La Porta, De-Silanes and Shleifer (2006) have examined the security laws of 49 countries in which Sri Lanka has been included. These authors construct two indices namely the disclosure index and the liability index to see the strength of the security laws in a country. The disclosure index is computed by number of dimensions. They are: (1) the nature of the prospectus in particularly the compliance of it in relation to legal provisions; (2) compensation of directors and (3) shareholder structure and inside ownership. Liability index comprises the ability of the investors to make a claim. Sri Lanka stands below the mean value of the English origin countries in all the indices (table 3.1: an extract from the full table). The first row shows the Sri Lanka situation and the second row shows the mean value for the countries where English law prevails. However, the value for disclosure is 0.75 and it is close to the mean value of 0.75. The value of regulations or the rule making power is 1.00 which is above the mean value of 0.67 (see table 3.1). In the discussion earlier, we identified a high regulatory environment in the country.

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[16] However, it should be noted here, that the COPE is a parliamentary body and if there are vested interests, there could be non disclosure of such issues even in countries like Sri Lanka where there are military oligarchies according to our experience in the last three decades.

Table 3.1

Sri Lanka – Indices of Regulation of Securities Markets

Disclosure requirements	Liability Standard	Supervisor characteristics	Rule making power	Investigative power	Orders	Criminal sanctions	Public enforcement
0.75	0.39	0.33	1.00	0.50	0.00	0.33	0.43
0.78	0.58	0.48	0.67	0.75	0.57	0.65	0.62

Source: La Porta, De-Silanes and Shleifer (2006:15).

There is evidence to show that implementation of the regulations too is increasing in recent years. In the annual report of the SEC (SEC, 2006), several cases of misconduct of the directors are mentioned along with the actions taken by the SEC. Among them is the selling of shares of family members of some directors at higher prices with the knowledge of sensitive market information. Such declarations in the annual report of the SEC on the conduct of the directors of the listed companies may deter the directors to violate the trading rules but there is no follow up research to identify its effect. However, Abeysekera (2001) writes that SEC has made substantial progress to ensure market efficiency with 'Freely available information, competition among investors and effective communication among market participants' (2001:251).

Perera (1980) writes that the responsibility and the emphasis of the auditors in Sri Lanka in early 1980s was to ensure that the company management prepares annual reports to show that there is a true and fair view of the accounts. Perera (1980:122) writes that 'There has been not much discussion in Sri Lanka of the rational behind them and the information value of the financial statements they generate'. This scenario has changed now. The ICASL organises an annual competition to select the best annual report among the listed as well as the unlisted corporate sector since 1964. Since 2000, this annual competition focuses on three areas namely Good Corporate

Governance Disclosure Award, Corporate Social Responsibility Reporting and Management Commentary Award. These awards are named as The Chartered Accountants Annual Report Awards.[17] Further, there is evidence to suggest that the authority is keen to see the implementation of the accounting and auditing standards.

Some international research studies find a better disclosure situation in Sri Lanka. Bushman, Piotroski and Smith (2003) in their research on corporate transparency of 45 countries selected during a period of five years from 1990 to 1995 and based on the largest companies of the countries selected, point out that there are some promising countries which can take up the challenge of developing corporate governance in par with the developed countries and Sri Lanka is one of them. These authors have taken number of variables namely financial disclosures (segments reporting, capital expenditure on research and development and others, accounting policies, declaration about subsidiaries), governance disclosure (size of major shareholders, management personnel, BOD and their remuneration, director and officer shareholdings), and accounting principles, timeliness of disclosures and credibility of disclosures as a per centage of the audited companies by the international audit firms Big 5[18]. The best disclosure of governance information according to their findings is Singapore (100 points) and next comes Sri Lanka (97.83 points)[19]. UK has got 94.57 points and the US has got only 75.72 points. In disclosure variables, the UK, Canada, Australia, France, Germany, Japan Ireland, Israel, Italy, Netherlands, Sweden and Switzerland are in equal footing (100 points) but the US is behind. Chairman of International Accounting

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[17] See the web site of the ICASL (http://www.icasrilanka.com/)

[18] Since Arthur Anderson was closed with the Enron scandal, it is now Big four.

[19] This situation is convinced without a doubt when the annual reports in the AIM companies are compared with a sample of annual reports of PLCs in Sri Lanka.

Standards Board (IASB) has praised the standards of accounting disclosures in Sri Lanka (Ceylon Daily News, 2005[20]).

Existence of number of regulatory bodies in Sri Lanka could be a possible factor for the high level of disclosure but empirical research has to establish this factor. However, we see that some of the economic sectors such as the commercial banks are required to comply with the guidelines of the CBSL, SEC, and ICASL, Registrar of the Companies and Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB). Apart from these, there are a number of requirements in the legal framework which demands disclosure needs, i.e. Companies Act, No. 7 of 2007, Banking Act, No. 30 of 1988, Security Council Act No. 18, 2003 to list few among them.

Although Bushman, Piotroski and Smith (2003) have not obtained the data on the number of audit firms in Sri Lanka and on the strength of the audit function in the PLCs during the period under their survey, in 2004, 80 per cent of the auditing of the corporate sector has been done by the international Big auditors according to the data tabulated by us using Handbook of Listed Companies (2004). According to Bushman, Piotroski and Smith (2003:213), '…audit is a measure of the credibility of financial disclosures, defined on the basis of the share of the total value audited by the Big 5 accounting firms'.

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[20] In the web site in which this page appears, it does not mention clearly the page number. This news item appears in the business page. We made an inquiry from the newspaper but did not reply to date. Downloadable from the following web site.
http://www.dailynews.lk/2005/05/03/bus23.htm

Although there is an international presence of audit firms, majority of the corporate sector has not yet developed audit committees. In a survey done by the SEC to see the level of establishment of audit committees, SEC found that only 62 per cent of companies have established audit committees (out of 132 companies responded to a survey of 239 companies as at July 20, 2005) (Audit Committees of Listed Companies in Sri Lanka, 2005). This report shows many grey areas in audit related functions such as the inclusion of the CEO and some other executives also in the audit committees. Pierce and Waring (2004) find that the audit committees in the listed companies in Sri Lanka spend only around 15 minutes together and in some occasions hardly any attendance by the full committee members even.

3.4 Challenges for the Efficient Functioning of the Regulations

Political interferences affect the implementation of the regulations in the country as found by many authors thus the protection of the interests of the shareholders and the other stakeholders are at stake even though the regulatory framework is in force (Weerakoon, 1995; Wickramasinghe, Hopper and Rathnasiri, 2004; Ratnayakara, 2006). Ratnayakara (2006) writes patriotically that there is an urgent need to protect the corporate sector in Sri Lanka from political influences.

> 'Despite all the rules and regulations protecting various stakeholders, we have seen gross violations against the rights of minority shareholders as well as customers and competitors in recent times by powerful individuals who are able to throw their weight and flex their muscle in addition to dropping names thus instilling fear in the minds of regulators, in resorting to the acts. Very often are powerful stakeholder infringes on the rights of other stakeholders, competitors, employees, minority shareholders and even the fellow directors' (Ratnayakara, 2006:1).

Nature of such political interferences has been documented by the OECD (2003) across the developing countries. OECD writes as follows:

> 'Civil servants or persons closely aligned with the government can be pressurised to use their positions to pursue political or social objectives of the government at the expense of the company. Such civil servants may also cause the company to enter into transactions for the private benefit of them or persons connected with them. These behaviours constitute abusive self dealing, and rules regarding definitions, disclosures and approval of 'related party transactions' should take into account the particular challenges presented by state ownership in listed companies' (OECD, 2003:23).

The politicians and the officers well understand the need to protect independence to develop free trade but they do not allow the legal framework to establish its root in the society (Irvin, 2001; La Porta *et el.,* 2004). La Porta *et el.,* (2004) find that politicians who get a rent from the business community prevent competition in order to enjoy the privileges. Business firms get abnormal profit as a result and they too make various barriers for the new firms to come. These findings are relevant to Sri Lanka too as we have seen the economic trends and the business climate for three decades since the introduction of the free economic policies in the country since 1977. World Bank (2006) reports that 'Data from the Worldwide Governance indicators for 2005 show that democratic accountability and clean government go hand in hand' (2006:7).

The freedom for the entrepreneurs to establish business could be measured by several indicators. Miles, Holms and O'Grady (2006) define economic freedom as 'The absence of government coercion or constraint on the production, distribution, or consumption of goods and services beyond the extent necessary for citizens to protect and maintain liberty itself' (Miles, Holms and O'Grady, 2006:56)[21]. In order to

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[21] But for a country like Sri Lanka which has an unsettled political situation mainly due to terrorism, total freedom for economic activities could not be ensured. At least in some sectors such as utilities, financial industry, manufacture of some items such as chemicals, firearms, fuel and so on have to be controlled for national interests and territorial integrity. These authors do not see this aspect other than purely looking from their measures of economic freedom.

measure economic freedom[22], these authors study fifty economic variables categorising them into ten broad categories, i.e. trade policy, fiscal burden of government, intervention of the government in the economy, monetary policy, capital flows and foreign investment, banking and finance, wages and prices, property rights, regulation and informal market activity. All of these variables are treated equally important. The overall economic freedom score of a country is based on the simple average of ten individual factor scores. The score for each factor varies from one to five. A score of one signifies an economic environment or set of policies that are most conducive to economic freedom, while a score of five signifies a set of policies that are least conducive to economic freedom. Four broad categories of economic freedom in the index are: Free (countries with an average overall score of 1.99 or less), Mostly free (countries with an average overall score of 2.00 to 2.99), mostly un-free (countries with an average overall score of 3.00 to 3.99) and repressed (countries with an average overall score of 4.00 or higher). According to this index, Sri Lanka belongs to mostly un-free category with a score of 3.19.

Economic and political freedom is two other significant factors which decide the state of protection of rights of investors in a country (Reed, 2004). La Porta *et al.,* (2004) measure political freedom by several sources, that is an index of political rights, democracy index, and index of human rights (2004:452). According to Barro (1999) which introduces an easy to understand measure of political rights, that is electoral rights, there are seven levels of political rights. Group one is the highest level of rights

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[22] La Porta *et al.*, (2004) use four measures of economic freedom. Subjective index of the security of property rights against infringement by the government, number of different steps that a start up business has to comply with in order to begin operating as a legal entity, intensity of regulation of the employment contracts and estimate of government ownership of banks.

and groups seven is the lowest. Sri Lanka has been included in between the democracy and dictatorship (Barro, 1999). Among many other factors, bureaucratic inefficiency (Mauro, 1995) and poor enforcement of law (La Porta *et el.* 1998) result in creating a large *shadow economy,* in developing countries including Sri Lanka (Schneider and Enste, 2000). These authors point out that the percentage of the shadow economy in Sri Lanka is around 38 - 50 per cent. This is no doubt a very large drain of, otherwise the legitimate property of the general public or the potential investors.

Filatotchev *et al.*, (2007) identified the significance of the role of institutional investors as a corporate governance mechanism. In a developing country like Sri Lanka, domestic institutional investors could play a vital role in many forms in the capital market as pointed out by Reisen (2000), i.e. by making information available, increasing market liquidity, lowering transition costs, facilitating market participation by the general public, helping businesses raising capital, making privatisation possible, playing a role in corporate monitoring and attracting foreign investors. According to Pierce and Waring (2004), investor activism and stakeholder activism is increasing in Sri Lanka but not sufficient. But we have found in chapter 2 that authors point out lack of shareholder activism in the developed capital markets too. If the monitoring of managers is done by only one institutional investor, the cost of monitoring has to be borne by such institution while the others get an advantage. On the other hand, shareholders are not so keen due to their different interests in life and portfolio diversification and the stakeholders are not also exactly identifiable due to the diverse nature of them. These problems found in Chapter 2, could be more or less similar to Sri Lanka too but it is required empirical investigation.

In conclusion of the above section, we could agree with authors who write that there is a highly regulated corporate sector in the country (Pierce and Waring, 2004) and promising future for corporate governance (Bushman, Piotroski and Smith, 2003), despite the challenges for the efficient functioning of the regulatory framework. The rapid growth of the corporate sector may have left the government towards a regulatory framework more and it could be argued even as imperative due to the early phase of learning the behaviour of the growth of the corporate sector. We venture to discuss below the salient features of the corporate sector in order to attempt to position the significance of the regulatory framework in this context (Johns, 2001).

3.5 Corporate Sector – Development from a Historical Perspective

Although Sri Lanka has a long history of the corporate sector, the unearthing of a recorded history of its development in relation to corporate governance variables such as investor protection, systems of managerial control and directorship, etc. is a challenge for a researcher. Herrigel (2006:1) writes that 'The history of corporate governance arrangements, understood as the constitutive processes shaping the relationship between ownership and management of enterprises, is a relatively new field of inquiry for business historians'. However, the Ceylon Banking Commission (1934)[23] explains in details, the nature of the money and capital markets existed in 19th

[23] This Commission was appointed in 1934 by the Crown government on a request made by George E. De Silva, a member of the Council. He argued that the credit needs of the indigenous businessmen are hardly met by the existing banks. The Commission found that the existing banking and financial system catered mainly to the foreign businessmen and sterling companies. Ceylonese were not approachable to these banks, but only with a higher interest rate and collateral, mainly the surety from two businessmen known to the banks. Commission held widespread sources of information about the nature of services of the existing commercial banks and recommended the establishment of a bank for indigenous business men. Accordingly, the present Bank of Ceylon was established in 1939.

century to 1930s. This report has an account of the ownership pattern of the financial intermediaries prevailed during the above period and the general economic situation of the country. Accordingly, the economy was an enterprise of the foreigners mainly British firms during its' colonial rule.

Acemoglu, Johnson and Robinson (2001) argue that the colonial economic policy had two strategic approaches in dealing with the colonies. Which policy was to be suitable for a particular colony was decided by the mortality rate of the colonisers, traders and missionaries. Accordingly, if the mortality rate among them was low when they moved to a colony, they decided to settle down and to develop the property rights as they enjoyed in their parent countries, that is common law by British and civil law by French (Acemoglu, Johnson and Robinson, 2001). Australia, New Zealand, and the US were chosen by the British colonisers as conducive for settlement as the above groups experienced less mortality. Therefore, the systems of law prevailed in Britain was developed in these countries.

Among the colonies, which had higher mortality rate but with natural endowments such as minerals, fertile land and weather for crops, such endowed colonies were used for the development of the parent country by exploiting to the maximum (Acemoglu and Johnson, 2005). Colonisers did not develop systems of law or administration as prevailed in their parent countries because they did not want to settle down in countries where there were high mortality rates. Ceylon and India were attractive for geo-political strategic reasons. British naval forces could control the entire Indian Ocean with the natural harbours. As a result, they developed the common law but not to the fully extent required to develop a capital market as in Australia and New Zealand

(Acemoglu, Johnson and Robinson, 2001)[24]. Beck, Demirgüç-Kunt and Levine (2003) argue that in an extractive environment, colonisers did not construct institutions that favour the development of competitive markets as they saw the competitive markets could threaten the position of the extraction.

Morgan (1958) writes in a review of a book (Oliver, 1957), that British colonial government has an unfair treatment for Ceylon[25] in several ways. In the nineteenth century the government took title to wide areas of uncultivated hill land in Central Ceylon and sold them to British planters[26]. This action seems to Ceylonese critic's legalized theft[27], since the lands were something like Europe's medieval commons-sources of pasture and fuel, and potentially areas for expansion of village cultivation. Another allegation is that taxation took income away from Ceylon, and used to pay salaries and pensions to British civil servants. In order to find large scale capital for the plantation industry, the Colombo Share Brokers Association was established in 1896 (CSE, 2004). Plantation sector companies were the most significant in the corporate sector in the country untill mid 1970s (Report of the Commission of Inquiry on

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[24] La Porta *et el.*, (1998:1115) argue that legal institutions across the world is a result of 'A combination of conquest, imperialism, outright borrowing, and more subtle imitation'.

[25] Since independence from the Britain, the country name Ceylon was replaced as Sri Lanka.

[26] The Waste Land Act of 1832 was implemented by the colonial government and accordingly Ceylonese who could not claim for land by documentary evidence lost the possession of their lands. These lands were sold to British planters and to civil servants subsequently at cheaper prices (Ceylon Banking Commission, 1934).

[27] Reed (2004) explains that it is difficult to give a precise meaning for the word 'property'. 'When there was a time in *nature* when everyone had a common use of physical resources, and when the state privatised resources for an individual through property – thus depriving everyone else of the common use of resources, it is a type of theft' (2004:459).

Agency Houses and Brokering Firms, 1975[28]; Moore, 1997). However, the growth of number of sectors in the economy since the liberalisation of the economy in 1977 has reduced the significance of the plantation companies, both in the corporate sector as well as foreign exchange earnings (Central Bank of Sri Lanka, 2005).

Lakshman (1985) points out that although some form of capitalist organisation took root in certain sectors of the economy like plantations and selected service sector activities, the colonial government did not produce the necessary conditions for an organic development of capitalism on a wide front and the surpluses generated too were largely sent abroad, leaving very little for further accumulation domestically. Moore (1997) reports that some British firms engaged in tea auctions both as buyers and sellers undercutting the prices and in controlling everything from plantation to retail trade. This situation has happened not only in Sri Lanka but in Indian plantation industry owned by the British planters (Tharian, 1984).

Tharian (1984) argues that the British planters and the owners of the plantation companies repatriated profits in under invoicing. They even protested the opening of an indigenous bank for Ceylonese through the representation made by the Ceylon Chamber of Commerce (Ceylon Banking Commission, 1934). Dyck and Zingales (2004) argue that the growth of financial institutions of a country needs the blessings of the large scale and influential businessmen who have the ability to negotiate and

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[28] The government of Sri Lanka which came into power in 1970 was a coalition of three political parties which had accepted central planning of economic enterprises under the ownership of the property by the government. As a result, government appointed this Commission to look into the ownership pattern of the land both cultivated and waste land owned by Sri Lankans and foreign companies. Accordingly, the land owned by foreign firms was acquired by the government and managed subsequently by government enterprises. Many of these plantation companies belonged to British.

bargain with the governments for favourable trade legislation. In those countries where they did not come forward to bargain with the government to get favourable trade regulations, capital markets did not grow.

Even after getting independence in 1948, and until a considerable period, the colonial legacy prevailed in the country while the assistance programs of the World Bank and the International Monetary Fund had no serious involvement to develop the capital market (Lakshman, 1985). Partly responsible for this is the 'Westernized elite's continued domination of power' (Oberst, 1985:760) and acceptance of economic models by the policy planners in some key government institutions either due to the privileges they enjoyed such as scholarships and other key posts in these organisations (Goonetilake, 1975). Apart from the above factors, Sri Lanka has experienced 'repeated turnarounds in economic policy' (Snodgrass, 1998:1). Governments in the 1950s, 1960s and 1970s spent large sums of money on social welfare programs and in state economic activities (Blackton, 1983). La Porta, De-Silanes and Shleifer (1999) argue that in heterogeneous societies as in Sri Lanka, governments are compelled to intervene in economic activities in order to pacify the diverse interests of a heterogeneous society.

The inability of making a coherent economic policy prescription conducive to economic growth and development (Todaro and Smith, 2005), was due to different political ideology and the accompanying economic policy of each government which came to power unseating the incumbent government in each general election since independence in 1948 (Snodgrass, 1998). Snodgrass (1998) and Nithiyanandam (2000) have documented how each government which has come to power in Sri Lanka changed economic policy with its own political ideology and its impact on the

economy[29]. Nithiyanandam (2000) writes that Sri Lanka was an 'Economic Laboratory' (Nithiyanandam, 2000:284). However, Moore (1997) points out that many changes in the international environment such as the liberalisation of economies world wide and competition for foreign equity flows and foreign direct investments among developing countries led to a common understanding of the need to develop the country on a coherent economic policy and led the acceptance of the free market policies by all the mainstream national political parties.

As table 3.2 above shows, large number of countries have liberalised their stock markets all within a decade i.e. 1987 - 1996. Hoskisson, *et el.*, (2000) point out that developing countries in Asia, Africa, Latin America, Middle East countries and also the transition countries in the former Soviet Union believed that market economic policies would be useful to develop their economies. These countries compete to attract foreign direct investments and equity flow. Moore (1997) writes that Colombo Share Market was also successful to attract investment. This author writes that 'In 1994, for the first time ever, the stock market became the largest single source of new capital for the private sector' (Moore, 1997:360).

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[29] There are two major political parties in Sri Lanka, that is Sri Lanka Freedom Party (SLFP) which advocates socialism and state capitalism and a foreign policy which has a historical tendency to tilt towards the socialist countries (the former USSR and Mainland China) and United National Party (UNP) with a pro western foreign policy and liberal economic policy which favour the private ownership of property. Blackton (1983:736) writes 'The maze of industrial policies promulgated by alternating UNP and SLFP governments left Ceylon with a set of inefficient import substitution industries surviving behind excessive rates of effective protection and a lack of the international marketplace and sheltered from the winds of international competition'.

Table 3.2

Equity Market Opening in Emerging Countries

Country	Official Liberalization Date (YY/MM)	First ADR Introduction (YY/MM)	First country fund introduction (YY/MM)	Estimate of Increase in Net US capital flows
Argentina	89.11	91.08	91.10	93.04
Bangladesh	91.06	na	na	na
Brazil	91.05	92.01	87.10	88.06
Chile	92.01	90.03	89.09	88.01
Colombia	91.02	92.12	92.05	93.08
Cote d'Voire	95.00	na	na	na
Egypt	92.00	96.11	na	na
Greece	87.12	88.08	88.09	86.12
India	92.11	92.02	86.06	93.04
Indonesia	89.09	94.04	89.01	93.06
Israel	93.11	87.08	92.10	na
Jamaica	91.09	93.06	na	na
Jordan	95.12	97.12	na	na
Kenya	95.01	na	na	na
Korea	92.01	90.11	84.08	93.03
Malaysia	88.12	92.08	87.12	92.04
Mexico	89.05	89.01	81.06	90.05
Morooco	88.06	96.04	na	na
Nigeria	95.08	98.05	na	na
Pakistan	91.02	94.09	91.07	93.04
Philippines	91.06	91.03	87.05	90.01
Portugal	86.07	90.06	87.08	94.08
South Africa	96.00	94.06	94.03	na
Sri Lanka	**90.10**	**94.03**	**na**	**na**
Taiwan	91.01	91.12	86.05	92.08
Thailand	87.09	91.01	85.07	88.07
Trinidad and	97.04	na	na	na
Tunisia	95.06	98.02	na	na
Turkey	89.06	90.07	89.12	89.12
Venezuela	90.01	91.08	na	94.02
Zimbabwe	93.06	na	na	na

Source: Bekaert, Harvey and Lundblad (2003:277). n.a = not available

Table 3.3 shows the rapid growth of the number of quoted companies during the period of 1977 to 2004. The number of quoted companies during the period of 1977-2004 is 180. Number of established companies during this period is 141. The number of companies quoted during this period exceeds the number of companies established. This shows that many companies which have been registered prior to 1977 have sought equity capital. Chapter 2 (section 2.3), explained the limitations of the private firms and the need to seek equity capital in order to expand (Marris, 1998; Vives, 2000). On the other hand, growth of the number of quoted companies since 1977 shows the expectations of the investors as well as the entrepreneurs.

Table 3.3

Number of Established and Quoted companies

Age analysis	**Established**	**Quoted**
Before 1900	4	0
1901 – 1947	28	5
1948 – 1976	67	44
1977 – 2004	141	180

Source: Survey data compiled using Handbook of Listed Companies 2004, Colombo Stock Exchange

Table 3.4 shows the number of years taken by the companies to get listed since registration. Accordingly, 127 companies (55 per cent) have sought listing during the first five years of incorporation. Economy in Sri Lanka was growing as a result of the liberal economic policies introduced in 1977 and the companies seized the opportunities. Among the factors which motivated the registration of new companies was also the relative ease of registering a company under the Company Act No. 17 of 1982. For example, there were no regulations for the finance companies in relation to

the minimum capital needs and single shareholder ownership limitations as enforced in the 1988 Finance Companies Act.

Table 3.4

Age Analysis of the Corporate Sector (Gap = Difference between established year and the quoted year)

Gap years	**No of companies**
0 – 5	127
6 – 10	37
11 – 15	20
16 – 20	16
Over 21	32
Total	**232**

Source: Survey data compiled using Handbook of Listed Companies 2004, Colombo Stock Exchange

In 2002, the Government of Sri Lanka gave the non-nationals the permission to buy shares to the full value of issued capital of a listed company either through approved country funds, regional funds, corporate bodies or as individuals subject to some exclusions and limitations (Circular Letter, 2002). The exclusions come in respect of the companies engaged in money lending, pawn brokering and retail trade with a capital of less than one million US dollars. Limitations were enforced in respect of buying shares only up to 40 per cent of the issued capital of companies engaged in several business sectors. They are: production of goods where Sri Lanka's exports are subject to internationally determined quota restrictions, growing and primary processing of tea, coconut, cocoa, rice sugar and spices, mining and primary processing of non renewable national resources, timber based industries using local timber, deep sea fishing, mass communication, education, freight forwarding, travel agencies, and shipping agencies.

Table 3.5 shows that there is a dispersed ownership of shares and the significance of the minority shareholders. Large number of shareholders (86.7 per cent of total shareholders) holds less than 1,000 shares while there is a tiny fraction among the shareholders who own a range of holdings above the category of 50,000 shares. Samarakoon (1999) finds this pattern of distribution in a sample of companies.

Table 3.5

Size distribution of Shareholdings among the Shareholders (174 companies)

Number of shares owned	**Number of shareholders**	**Per centage of total***
Less than 1,000	524,530	86.7
1,001 – 5,000	53,521	8.5
5,001 – 10,000	13,042	2.2
10,001 – 50,000	10,021	1.7
50,001 – 100,000	1,489	0.2
100,001 – 500,000	1,403	0.2
500,000 – 1 million	291	0.04
Over 1 million	589	0.1
Total	604,886	100

Source: Survey data compiled using Handbook of Listed Companies 2004, Colombo Stock Exchange

Note: * approximately and total will not come to 100 per cent.

Moore (1997) and Samarakoon (1999) find substantial director ownerships and family ownership in the listed companies. However, these authors have not studied the extent of analysing the ultimate ownership of the corporate sector in Sri Lanka. La Porta, De-Silanes and Shleifer (1999) point out that the controlling interests of the companies are more important as the control benefits exceed the cash flow rights.

The average number of directorships in a quoted company has increased from 3.8 in 1951 to 5.4 in 1971. However, a remarkable development during the period of 1988 to 2004 is the number of directorships remaining without much change from 7.1 in 1988 to 7.2 in 2004, but a marginal increase. However, there are several noteworthy features in relation to the directorships. First, average number of directorships per director has gradually decreased since 1951 to 2004 (from 2.8 to 1.5). Number of directors holding only one directorship also have increased. Number of directors who hold multiple number of directorships (more than 10 directorships) also have decreased gradually since 1951. However, there is virtually a lack of research studies on the nature of directorships Sri Lanka. Therefore, this is a researchable area in the corporate sector in Sri lanka.

Table 3.6

Distribution of Directorships of Quoted Companies, 1951, 1971, 1988 and 2004*

	1951	**1971**	**1988**	**2004**
Number of quoted companies	189	153	176	243
Total number of company directorships	718	824	1256	1766
Average number of directorships per company	3.8	5.4	7.1	7.2
Average number of directorships per director	2.8	2.2	1.6	1.5
Per cent of directors holding only 1 directorship	55	67	75	76
Number of directors holding 10 or more directorships	14	12	4	8
Per cent of directorships held by persons holding 10 or more directorships	22	17	4	.06

Source: Moore (1997:353) and Handbook of Listed Companies, 2004

Note: * Based on the directorships compiled using Handbook of Listed Companies 2004, Colombo Stock Exchange.

The financial statements of listed firms are audited by audit firms registered in Sri Lanka. Some of them are the branches of international audit firms. Table 3.7 shows that 90 per cent of companies are audited by three international audit firms namely, KPMG, Ernst and Young and Price Waterhouse Coopers[30]. The number of companies audited by them in 2004 is 98, 70 and 22 respectively (Table 3.7). There are number of Sri Lankan audit firms and of them, three local Big firms (HLB Edirisinghe, Kreston M N S and Ford Rhodes Thornton) audit 17 companies. Small companies in terms of turnover and assets are audited by individual audit firms. Literature suggests that when the auditing is done by an international audit firm, better corporate transparency could be expected (Bushman, Piotroski and Smith, 2004).

Table 3.7

Concentration of Auditing of Corporate Sector

Name of the audit firm	**No of firms**
KPMG	98
Ernst and Young	70
PriceWaterhouse Coopers	22
HLB Edirisinghe & Co	7
Kreston M N S & Co	6
Ford Rhodes Thornton	4
Each auditor having three firms	12
Each auditor having two firms	8
Single auditors each having one firm	12
Total number of firms	239

Source: Survey data compiled using Handbook of Listed Companies 2004, Colombo Stock Exchange

The literature on the significance of the company secretary in corporate governance has not been researched adequately according to the arguments of Nicholson and Kiel

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[30] However, a notable feature is the lack of the presence of Deloitte audit firm in Sri Lanka. For an inquiry made through email to understand whether there is a branch of this firm in Sri Lanka, London office of this firm confirmed the same.

(2004). 'A governance role that is changing in significant ways is that of the company secretary. Although the role if less important in smaller companies, it is becoming more important in larger organisations where the company secretary is increasingly charged with ensuring good governance and compliance' (Nicholson and Kiel (2004:12). Stiles (2001) among the multiple number of research methods, has sent a postal questionnaire to company secretaries to get their views on the role of the NEDs. Companies Act in the UK (sections 272 to 279 in 2006 Companies Act) and Sri Lanka (sections 221 and 222 in Companies Act, No. 7 of 2007) mention about various aspects of the company secretary such as the appointment, duties and qualifications. However, the Companies Act of Sri Lanka does not specify the membership of professional bodies and the period of service experience required to practice as a secretary as in the UK Act of above.

There are 102 listed companies which get the service of a company secretary in Sri Lanka (table 3.8). There are two types of company secretaries in the country: (1) legal and accountancy firms functioning as company secretaries (may be while providing other services such as legal consultancy and accounting respectively) and (2) individual secretaries (mainly lawyers and chartered accountants to our best knowledge). Among the legal and accountancy firms which function as company secretaries, one of them serves 16 companies, while the majority of the companies in the corporate sector is served by individual secretaries (number of firms 52) (table 3.8).

Table 3.8

Concentration of Corporate Secretarial Function

Number of listed firms	**No of secretarial firms**
Only 1 by each secretariat firm	16
Only 2 „	6
Only 3 „	8
Only 4 „	4
5 – 10 firms	6
11 – 15 firms	4
16 – 20 firms	1
Sub total	**45**
Number of listed firms	**Number of individual secretaries**
Each by one	52
Two firms	5
Sub total	**57**
Grand Total	**102**

Source: Survey data compiled using Handbook of Listed Companies 2004, Colombo Stock Exchange

Company secretarial function is considered as a vital element in linking the shareholders with the management and the BOD of a company (Companies Act, 2006). Therefore, it is required to pay attention to the argument of Nicholson and Kiel (2004) who point out the lack of studies on this vital function and the need for research.

3.6 Conclusion

The above discussion points out that Sri Lanka has a growing corporate sector and a large scale regulatory framework. Authors have found such a large scale regulatory environment in the country with the growth of the corporate sector especially since the introduction of the free market policies in 1977 (Samarakoon, 1999; Chandrakumara and Budhwar, 2005; Batra, 2006).

However, as Anand (2006) points out the balance of both regulatory and non-regulatory codes on corporate governance brings harmony and less cost for both companies and the regulators. However, this author argues that statutory rules and regulations enforce compliance cost for the companies and even could stifle the growth of the corporate sector especially the firms seeking the equity capital. We have discussed in Chapter 2, that the *Sarbanes-Oxley Act 2000* has discouraged some firms to enter the equity market and also some firms now tend to go back to leveraged buy-outs and privatise (Dalton and Dalton, 2005; Zhang, 2007).

The regulatory bodies also have to meet the cost of maintenance of office and a professional staff to see that listed firms comply with the regulations (FSA, 2006). However, if there are only non-regulatory codes on corporate governance, the investors have to bear the cost of verifying the state of corporate governance in each and every firm they wish to invest (Anand, 2006). Investors are unable to find out the nature of corporate governance or about the true nature of declarations in financial statements due to the lack of knowledge and resources (Turnbull, 1997a). Due to information barriers, the investors would not be able to get a correct picture of the firms. Therefore,

a balance of both statutory regulatory and non-regulatory codes on corporate governance could be effective (Anand, 2006).

The most important corporate governance mechanism identified in literature is the BOD (Filatotchev *et al.*, 2007) and within the BOD, the role of the NEDs. Government of Sri Lanka has introduced a Code of Best Practices for the Public Enterprises (2003) but not for the corporate sector. Since there is only an introduction of a non-regulatory code on corporate governance in Sri Lanka, we could develop a model on the role of NEDs. Next chapter discusses the research methodology designed for this purpose.

Chapter IV

Research Methodology

4.1 Introduction

In the literature review in chapter 2, role of the NEDs in the context of non-regulatory codes on corporate governance has been discussed. In the context of the unresolved corporate governance problems, it was concluded that there is a need to look at the role of the NEDs again. Chapter 3 reiterated the significance of the role of the NEDs when the corporate sector in an emerging country develops past with the separation of management and ownership of PLCs.

The goal of the research methodology is to understand the role of the NEDs in the context of the implementation of the non-regulatory Codes on Corporate Governance. The aim is to design the research methodology only after making a review into the strengths and weaknesses of the existing research methodologies into the role of the NEDs. The objective is to execute the same with a view to identify a model on the role of NEDs useful for the corporate sector in Sri Lanka. The design of the research methodology discussed in this chapter is the result of a review of the existing research methods and methodologies into the role of the NEDs. There is a vacuum in research methodologies in relation to reliability, validity and replication of the research methodologies as well as biasness of seeing the role of the NEDs only through the shareholders' perspective. Role theory (Sarbin and Allen, 1968) argues the need to look at the role of the NEDs through the expectations of the constituents or the 'role senders' (Rogers and Molnar, 1976:598),

that is shareholders (Koehn and Ueng, 2005; Jong, Mertens and Roosenboom, 2006), employees from the top management which include the CEO to the lower management (Clapham and Cooper, 2005), and debtors (Day and Taylor, 1998) are a few most significant in addition to many others discussed in chapter 2.

Many authors point out the ability of getting a better understanding of a research problem through the use of different research methods simultaneously (Tashakkori and Teddlie, 1998: Stiles, 2001; Stiles and Taylor, 2001; Roberts, McNulty and Stiles, 2005). Accordingly, two research methods namely the content analysis and postal questionnaire are designed with the follow up of many guidelines in research methodology to ensure reliability, validity and replication of research design.

This chapter is organised as follows. Section 4.2 is aimed to identify the research methodologies and research methods in use to investigate the role of NEDs. The objective is to get methodological insights to design research methodology. By doing so, we could verify the argument of authors that there is a lack of development of a coherent research methodology and difficulty of getting methodological insights from the existing papers (Hung, 1998; Stiles, 2001; Hendry and Kiel, 2004; Huse, 2005). Section 4.2.1 discusses the methodological insights derivable which leads to the discussion of research methodology in section 4.3. Section 4.3 introduces the content analysis framework. Sub sections 4.3.1 to 4.3.13 explain the various steps of the content analysis which ensure reliability, validity and replication of content analysis. Section 4.4 and the subsections

explain the postal questionnaire design also giving attention for reliability, validity and replication. Section 4.5 will conclude this chapter.

4.2 Identification of Research Methodologies and Research Methods

Kosnik (1987) analyses the arguments of the Principal-Agency theory for the appointment of outside directors. The study uses secondary data to test the relationship between the decision to pay a higher price on a takeover attempt and the following variables, that is the nature of the appointment of the outside directors, contractual interests in the company, number of outside directors, equity ownership and executive experience. The regression analysis shows that the number of outside directors and executive experience are more significant than the other factors in preventing the payment of a higher price on a takeover attempt. This research belongs to 'analytical research methodology' (Gray, 2004:27).

Kesner and Johnson (1990) are also motivated to see the effectiveness of the outside directors within the BOD by looking into the relationship between the lawsuits and the number of outside directors in the BOD. They do a correlation analysis followed with the regression analysis. This paper belongs to the 'quasi experimental research' methodology (Gray, 2004:25) because there is no random selection of a sample. Authors get two sets of companies as samples. Each set has 56 companies. The difference of the two sets is that one set has no any lawsuits from shareholders while the other set has lawsuits against the directors. Since the authors use two samples of equal size of companies, which have been

sued and not sued by the shareholders, this is a matched design (Tashakkori and Teddlie, 1998). They find that the BOD, which had more outside directors, had fewer lawsuits.

Barnhart, Marr and Rosenstein (1994) also do a correlation and a regression analysis to test the argument for the appointment of the outside directors. They see the relationship between the performance of the company and the number of outside directors in the board with several control variables, i.e. managerial ownership, institutional monitoring, size of the board, advertising, research and development expenses, and leverage. The dependent variable of firm performance is measured by market to book ratio. Their research belongs to 'analytical survey methodology' (Gray, 2004:27). Analysis supports the view that the number of outside directors is a significant factor for the performance of the corporations.

Daily and Dalton (1994) too point out the ability of the outside directors to avoid corporate bankruptcies by being supportive to management and taking outside objective view in managerial work. They take two corporate governance variables, namely the nature of separation of the chair and the CEO and number of outside directors in the board. These are the explanatory variables. They take equal number of bankrupt firms and non-bankrupt firms. Bankruptcy is a binary variable in the study. They do a regression analysis and find that the bankrupt firms have the chair holding both chair of the BOD and the head of the top management team, more insider directors in the board and long tenure of them in their respective positions in the management.

Beasley (1996) analyses the ability of the NEDs to prevent frauds. Author takes fraud and no fraud companies to see the relationship between the frauds and the number of outside directors. This is a 'quasi experimental research' (Gray, 2004:25) since the selection of the sample is not done on a random basis. Secondary data is obtained from the *Wall Street Journal Index (WSJ Index)*. The hypotheses test results show that when the BOD comprises more independent directors with higher tenure in a firm, they are able to prevent frauds.

Conyon and Peck (1998) analyse the influence of the NEDs on the decision on the amount and method of compensation of the CEO. The study is based on the 'analytical survey methodology' (Gray, 2004:27). Authors prepare descriptive statistics and a regression analysis to test the hypotheses. They find that the top management pay and corporate performance is more aligned in companies with NED dominated boards and in remuneration committees. Hypotheses are: (1) top managers' compensation is expected to be negatively associated if the proportion of NEDs are greater on a firm's board; (2) companies with NED dominated boards will have a stronger link between their top managers' pay and corporate performance than other companies; (3) top management compensation is expected to be lower in companies that adopt remuneration committees or have a higher proportion of NEDs as members in the remuneration committees and (4) the link between pay and performance is expected to be greater in companies with higher proportions of NEDs in their remuneration committees. Authors collect data from two sources namely *Hemmington Scott Publishing Limited* and *Datastream International*.

Vafeas (1999) analyses the impact of the composition of the board on nomination of directors. This research study is based on 'analytical survey methodology' (Gray, 2004:27) since the collection of data is based on a random sample with control variables with 10 hypotheses. The measures for both independent and the dependent variable have been prepared using the previous literature. Findings are: First, the nominating committee cannot influence the number of outside directors that serves in the board. It is a determination of external factors, which surround the firm. And, second, the study finds that when the nomination committee has outside directors with heterogenic background, it prefers outsiders' directors with diverse skills. The results prove the hypotheses.

Stiles and Taylor (2001) have published the book titled *Boards at Work*. This book explains the role of directors in the PLCs in the UK. Main method of data collection is interviews. In addition, the authors use case study method too. They have put two techniques to secure interviews: (1) direct approach using third-party contact, by letter and through personnel contact and (2) indirect approach through referral. The authors have interviewed 51 directors (11 CEOs, 16 chairs, 13 executives and 11 NEDs). Sampling frame has been constructed within three constraints: (1) the directors had to sit on the main board; (2) the companies had to be UK owned and (3) the companies had to be public companies.

For the case studies of the above book, authors have selected four companies in the UK. They point out that the case study method is considered in social-science research as inferior and argue that scientific rigor could be maintained in social research also. In

addition to interviews and case studies, they point out that they have analysed company documentation such as annual reports, mission statements, policy documents, public relations material and analysts' reports. Although they disclose their research methods in details, they do not reveal how they categorise the roles of NEDs. Analysis of qualitative data such as interviews and case studies needs the development of criteria to classify data (McKelvey, 1975; Milne and Adler, 1999).

Laing and Weir (1999) analyse the relationship between the governance structures proposed by the Cadbury (1992) and the corporate performance in the UK. This research belongs to the 'analytical research methodology' (Gray, 2004:27). They do a regression analysis to see the relationship between the number of NEDs and sub committees of the BOD with the performance of the corporations. The data is from the *Price Waterhouse Corporate Register*. Authors conclude that Cadbury (1992) compliance and the performance of the companies has a positive relationship. In another publication by these authors (Weir and Laing, 2001), they do the same study again and conclude the same results after a regression analysis.

Stiles (2001) uses survey methodology to see the role of the directors in relation to strategy. Author has used several techniques to collect data, i.e. interviews with 51 company directors, a survey of 121 company secretaries by a postal questionnaire (response rate 13.4), 5 case studies and the interviews with the directors of the same companies, interviews with stakeholders (Institutional Shareholders Committee, the Consumers Association, London Stock Exchange, Bank of England, an analyst, an

environmental group and a city journalist) (Stiles, 2001:632). Reason for the multiple research techniques is explained by the author as lack of primary research to get theoretical insights to design the research methodology: '... a very small body of primary research on boards of directors from which to draw any methodological insights' (Stiles, 2001:631). Although the research methods are explained in details, the lack of how the categories are developed leaves the results questionable. This vital element in the development of the category points out the need to develop decision rules as we develop later for the content analysis.

O'Higgins (2002) analyses the selection and characteristics of NEDs and their roles in companies in Ireland with an in-depth interview with 22 NEDs and chairs but points out the difficulty of getting interviews from top management. This is an inductive method of research but as argued by many authors (Walliman, 2005, Tashakkori and Teddlie, 1998) there could not be a pure inductive method since the author could have pre-conceived concepts in mind in framing questions for interviewing. Author points out that the above number of interviews is adequate to represent the 'Irish Business life' (O'Higgins, 2002:21) with the following characteristics of the focus group: (1) board members of 8 of the largest 10 companies is included and (2) sample represents about three quarters of the total capitalisation of the Irish quoted companies. However, there is a lack of rigour in the application of the research method used due to the absence of the decision rules on the identification of the main tasks of the NEDs.

Ferris, Jagannathan and Pritchard (2003) introduce a construct named *Busyness Hypothesis,* which means that directors who serve on multiple boards become busy that they cannot monitor management properly. They do a regression analysis along with the correlation study between the chosen independent and dependent variables. They use the 'analytical survey methodology' (Gray, 2004:27). Analysis of the data shows that 84.39 per cent of directors hold only one directorship.

Pye and Camn (2003) investigate the role of NEDs. They explain their research methodology as follows: 'We agreed that our best solution to answering some of our research questions was to combine methods, drawing on a range of different inputs and approaches' (2003). Accordingly, one of the methods is to utilise their own experience to interpret the data. They write: 'The first author has 17 years of experience of researching and publishing in this field ... second author has 20 years' experience ... at board level' (Pye and Camn, 2003: 62). They further write that both of them worked with Hay Group Consultants on their 2002 survey of views of remuneration committee chairmen and institutional investors. These two authors write that they introduce the roles of the NEDs using the above survey data and 'experience refereed to above' (Pye and Camm, 2003:63). Therefore, there is a difficulty of identifying the dimensions[1] of the roles they introduce since they heavily depend on their experience to introduce four roles (Auditor, Super NED, Tame Pensioner and Consultant). Further, on what ground the roles are labelled as above is not explained. These deficiencies highlight the need to pay attention

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[1] 'Dimension is an aspect of a culture that can be measured relative to other cultures' (Hofstede and Hofstede, 2005:23).

in the research methodology for replication of the studies in a different context and for greater validity and reliability.

Pass (2004) analyses the level of implementation of the Cadbury guidelines (Cadbury, 1992) on NEDs and formation of sub committees in the BOD. On an inquiry made by us on the collection of data, author informs that he collected 51 annual reports and summarised the data into several tables on several dimensions such as the number of NEDs per annual report and sub committees of the BOD. However, author has not attempted to collect data by preparing a research instrument such as a 'content analysis schedule' (Jauch, Osborn and Martinm (1980:524-525). As such, the method of data collection is not identifiable in the paper. The significance of this lack of disclosure is vital to understand the difficulty of replicating the study by a successor and the need for the development of decision rules for greater acceptability of a discovery.

Fairchild and Joanne (2005) develop several hypotheses to see the relationship between the quality of directors and firm performance. They use the 'analytical survey methodology' (Gray, 2004:27) and do a regression analysis followed with the correlation analysis. In order to understand the nature of analysis, the model is reproduced below along with the definition of the variables.

$$HPR_{i,n} = \beta_0 + \beta_1 Responsibility + \beta_2 Influence_{i,} + \beta_3 Age + \beta_4 Tenure_{i,} + \beta_5 Professional_{i,} + \beta_6 Independence_{i,} + \beta_7 BoardSize_{i,} + \beta_8 Duality_{i,} + \beta_9 TargetPerf_{i,} + \beta_{10} TargetMV_{i,} + \beta_{11}(HMV_i/TMV_{i,}) + e_{i,}$$

$HPR_{i,n}$ = the holding period return for the hiring firm n years after the appointment of director I; *Responsibility*$_i$ = 1 if director I is a block holder, top management of an outside firm, or a venture capitalist; 0 otherwise; *Influence* $_{i,}$ = 1 if director I was hired after the CEO was hired, 0 otherwise; Age $_{i,}$ = the age, in years, of director $_I$; Tenure$_i$ = tenure of director $_i$ in the target firm; Professional $_I$ = 1 if the director $_i$ holds more than one directorship other than the target firm's board; 0 otherwise; Independence $_I$ = 1 if the per cent of outside board members of the firm hiring director $_i$ is greater than 50 per cent; 0 otherwise; BoardSize $_i$ = the number of directors on the board of the firm hiring the director $_i$; Duality $_i$ = 1 if the CEO of the firm hiring director $_i$ is also the chairman of the board; 0 otherwise; TargetPerf $_i$= holding period return of the target firm of director $_i$ measured from three years before the takeover to four weeks prior to the takeover; TargetMV $_i$ = target firm market value of director $_i$ three years prior to the announcement date of the takeover; (HMV_i/TMV_i) = ratio of the market value of the firm hiring director $_i$ to target firm market value of director $_I$; e_i = error term. Control variables are the age, tenure, duality of titles, independence of the board of directors BOD and the size of the board. The authors use several databases to collect data: *Mergers and Acquisitions database (SDC), EDGAR* database and *Silver Platter's SEC Online* and *Lexis-Nexis*.

Belden, Fister and Knapp (2005) see whether the outside directors are capable of reducing agency costs. Motivation for this research is explained by them as follows. 'Because there is conflicting evidence about whether or not more outside directors results in higher dividend payments, we again tackle the problem' (Belden, Fister and Knapp, 2005:175). The research is using the 'analytical research methodology' (Gray, 2004:27).

They use prior research to identify the variables, measures for them, develop hypotheses and test them. Authors use the ordinary least square regression method along with the correlation analysis. They find that the outside directors are able to prevent excessive expenses of the managers. They present the following general equation:

> Dividend policy = f(outside directors, revenue, assets, debt-to-market value, stock price volatility, number of directors greater than the mean, the year of the observation, two digit SIC code, executive compensation and fixed effects).

Roberts, McNulty and Stiles (2005) have done semi-structured interviews with chairs and NEDs (total 40) in order to comply a request of the Higgs review (Higgs, 2003). As the chairs and NEDs are made to explain their role, research is based on 'phenomenological research methodology' (Gray, 2004:27). In the analysis of data, they introduce three roles of the NEDs (1) engaged but non-executive, (2) challenging but supportive and (3) independent but involved. However, they do not explain how they classify the interview data into the above three categories. This paper too highlights the need to develop decision rules (Milne and Adler, 1999). This methodological deficiency was seen earlier in several studies (Stiles, 2001; Stiles and Taylor, 2001; O'Higgins, 2002; Pass, 2004).

Fich and Shivdasani (2006) analyse whether the outside directors are effective monitors. They use the 'analytical survey methodology' (Gray, 2004:27) with the construction of hypotheses and regression analysis. Sample consists of firms that appear in *Forbes* 500 list during the 7 year period from 1989 to 1995. The criteria of data collection are as

follows. First, each company has at least two consecutive years of financial data available from the *Compustat* and *Edgar* database. For each firm, the proxy statements have been collected. Final sample consists of 3,366 observations across 7 years. Testing of hypotheses use ordinary least square regression method with several controlling variables and the test results support the hypotheses.

Filatotchev (2006) analyses how the CEOs of companies of IPOs get outside directors to the BOD with the argument that there is lack of research on the role of NEDs in the IPOs. Author tests six hypotheses and do a regression analysis. The data has been extracted from the LSE on the IPOs between 1, December 1999 to 31, December 2000. Prospectuses of the IPOs have provided the information on career histories of board members, pre and post IPO ownership of managing officers, directors and large shareholders. *Global Access Database* is the source for prospectuses. Author concludes that the CEOs of IPOs take NEDs, evaluating their own strengths and weaknesses in management, experience of business, skills and ownership.

Westhead (1999) analyses the factors, which drive the unquoted companies to recruit the NEDs. Author explains that the research is filling a vacuum in corporate governance research in the small business sector. The sample comprises 905 companies in the UK and these are categorised into three according to the number of employees that is 1 - 9 employees, 10 - 49 employees and more than 50 employees. Accordingly, a stratified sampling has been done. Postal questionnaire method has been used. However, as author uses prior literature on the role of NEDs and test whether the NEDs have the same roles

in the small sector firms too, the identification of anything new in relation to the roles of NEDs could not be expected. However, the author identifies seven roles of the NEDs by classifying the data on the frequency analysis.

Deakins, O'Neill and Mileham (2000) interview 46 CEOs in small entrepreneurial firms in Scotland. Although they categorise the interview data into several roles on the frequency values of the distribution of the data but do not explain how they have developed the categories. Such qualitative data needs the application of content analysis methodology with explicit decision rules (Milne and Adler, 1999). However, as argued earlier, the lack of rigour emphasises the need to prepare explicit rules for replication of the research in a different context as well as for greater validity and reliability (Bacharach, 1989).

Berry and Perren (2001) analyse the role of NEDs in the small and medium scale companies in the UK. They send a postal questionnaire to CEOs of 5,279 companies selected on a random basis from the Yellow Pages Business Data Base. Questionnaire has been built on the literature survey into the role of NEDs in the large corporations. However, they do not present their questionnaire as well as do not disclose how they have categorised the roles of the NEDs other than clustering them on the frequency analysis. Therefore, the replication of their research into a different context or in the same context by a different author is difficult. The response rate for the postal questionnaire is 20.9 per cent. These authors divide the responses into the following categories on the frequency value: (1) outside objectivity; (2) strategic planning process; (3) financial expertise; (4)

operational expertise; (5) network of contacts; (6) structured board procedures; (7) helped with growth problems; (8) marketing support; (9) reduced board conflict and (10) prestigious name on the board.

Long, Dulewicz and Gay (2005) find the differences of the NED role in the listed (FTSE 100 and 250) and the unlisted companies (family and VC backed companies) in the UK with a series of semi - structured interviews with 25 NEDs. However, they do not disclose the interview schedule or the semi-structured questionnaire in the paper. They find that in unlisted companies, the NEDs have a task variety that is involvement in strategy, financial monitoring, and shareholder communication in more contribution but in some aspects, a lesser contribution that is monitoring of managers, executive remuneration, successor planning and appointment of directors. It is difficult to see how they categorise the data. This emphasises the need to develop the decision rules regarding categorisation for greater reliability and validity as well as replication of the study.

Heuvel, Gils and Voordeckers (2006) study the role of the BOD in small and medium scale family business firms. This paper has number of methodological insights that is use of theory, preparation of questionnaire and discussion of data. They construct several criteria in the sampling process. Authors send a structured postal questionnaire to 3,400 firms and get a response rate of 9.1 per cent (311 completed). They write that the questionnaire was developed by looking into the existing literature into the role of NEDs. Completed answers are evaluated to see the relative frequency of the responses. They

write that 'It is indispensable to differentiate between two aggregated roles that boards in small and medium-sized family firms perform: control and service' (2006:467).

4.2.1 Methodological Insights and Research Methodology

According to the above discussion, authors explain the contribution of NEDs through several research methods: (1) analytical survey methodology; (2) interviews (3) case study method and (4) postal surveys. Research studies which test hypotheses with the data available in data bases are unable to understand some of the tasks of the NEDs discussed theoretically in the literature, that is scanning the environment, sense making to develop strategic plans, attitudes, perception, beliefs, expectations, assumptions or considerations (Rindova, 1999; Forbes and Milliken, 1999; Haleblian and Rajagopalan, 2006). It is vital to understand such behavioural tendencies of the NEDs and the BOD. For example, if the failure of a certain strategic move were attributable to environmental factors (in self-defence by the management as well as the BOD), the same strategy would be continued without making the needed changes in the internal control systems (Forbes and Milliken, 1999; Hillman and Dalziel, 2003). Although the interview method is appropriate to see the above cognitive tasks of the NEDs, there are no such studies other than the interviewing of the NEDs to see whether they have the roles discussed in the literature as strategy, advice and monitoring. Even these studies have methodological deficiencies, which prevent replication of the studies as found in the review.

There are other concerns too about the papers of many authors. Bourgeois (1979) and Huse (2005) question the reliability and the validity of the papers mainly published in the US. Huse (2005) writes '… During the end of the 1980s and the 1990s, most research on boards and corporate governance had a US-inspired deductive approach, driven by the 'publish or perish' syndrome that is dominating the US academic community. Doctoral students and scholars in tenure track positions have preferred research using easily available data and methods that can be evaluated by journal reviewers through well-established validity concepts' (Huse, 2005:66). Bourgeois (1979:443) points out this in three decades ago. 'One might reasonably attribute part of the imbalance to the preponderance of empiricism in most doctoral-level training'. Due to this factor, this author argues that 'Current generation of organizational researchers attempt to either extend or verify extant theory through empirical investigation' (Bourgeois, 1979:443).

Questions raised by the above authors (Bourgeois, 1979; Huse, 2005), make us to understand why Chia (2002) suggests looking at the research results with a certain degree of scepticism. Studies of Laing and Weir (1999) and Weir and Laing (2001) use the same data and same methods of analysis to investigate the same research problem. Similar question could be raised on the work of Stiles (2001) and Stiles and Taylor (2001), due to the description of the data being similar. However, Stiles (2001) lists a large number of roles (table 6.1 in Chapter 6). When there are such repetitions, it is difficult to discard the advice of Chia (2002) to look at the research findings carefully.

Notwithstanding the above findings, there is general agreement among the authors on the lack of adequate research into the role of NEDs, lack of proper rules and the inability to agree for a common method to name the roles of the NEDs (Stiles, 2001; Stiles and Taylor, 2001; Pye and Camm, 2003: Hendry and Kiel, 2004 to name a few).

In the above context, there are two significant factors which give direction for the choice of the research design discussed below. First, the above analysis into the methodologies and methods of research suggest the lack of comprehensiveness in treatment to ensure reliability and validity (Bacharach, 1989; Sutton and Staw, 1995). Second, many authors point out the usefulness of several methodologies and research methods[2] to solve a research problem (Tashakkori and Teddlie, 1998; Stiles and Taylor, 2001; Roberts, McNulty and Stiles, 2005). Understanding the behavioural dynamics of top management personnel could be benefited by triangulation in research, as they are not easily testable through archive data and also they are not easily approachable for interviews and to see observe how the NEDs work in the board rooms (Mace, 1971; Pettigrew, 1992; Stiles and Taylor, 2001; Stiles, 2001; Pye, 2002b; Starkey, 2002; Samra-Fredericks, 2000a and 2000b).

The role of the NEDs has been discussed in a majority of the papers in the literature through the perspectives of the shareholders. Another vital role sender as explained in

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[2] This multiple methods and methodologies are called as triangulation in research: Accordingly, several theoretical perspectives (epistemological perspectives: scientific, subjective or constructive), methodologies (survey, phenomenology, ethnography) and research methods (questionnaire, interviews, documentary analysis to name a few). See: Gray (2004) for a brief introduction and Crotty (2003) and Tashakkori and Teddlie (1998) for a lengthy discussion.

section 4.4.1 is the CEO. The role of the NEDs is investigated through the perspectives of the CEOs by getting the views of a sample of CEOs through a postal survey. Later the postal survey is discussed in details. We ask the CEOs to give opportunities to interview in order to shed lights further on the data collected through the postal survey. We could verify ourselves the difficulty experienced by many authors to get interviews with the top management people such as directors and CEOs and inadequate response rates for postal questionnaires (Pettigrew, 1992; Stiles and Taylor, 2001; Stiles, 2001; Starkey, 2002 a few to mention). Then only we could tend to believe or dispute the arguments of the above authors. Next, designing of research methods is discussed in details.

4.3 Content Analysis Framework – Introduction

Content analysis for this research is a documentary analysis.[3] The documents are the annual reports of AIM companies listed in the LSE. The reasons for selection of these are explained later in details. Following aspects of the content analysis technique are discussed below, that is how the validity, reliability and stability is ensured with the development of the coding instrument, coding decision rules, stages of coding, open coding and development of main categories, analysis of the coded data and method of discussion of coded data.

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[3] Under documentary analysis, there are many types of documents and therefore, the specific rules of analysis change accordingly (see: Neuendorf, 2002; Kippendorff, 2004).

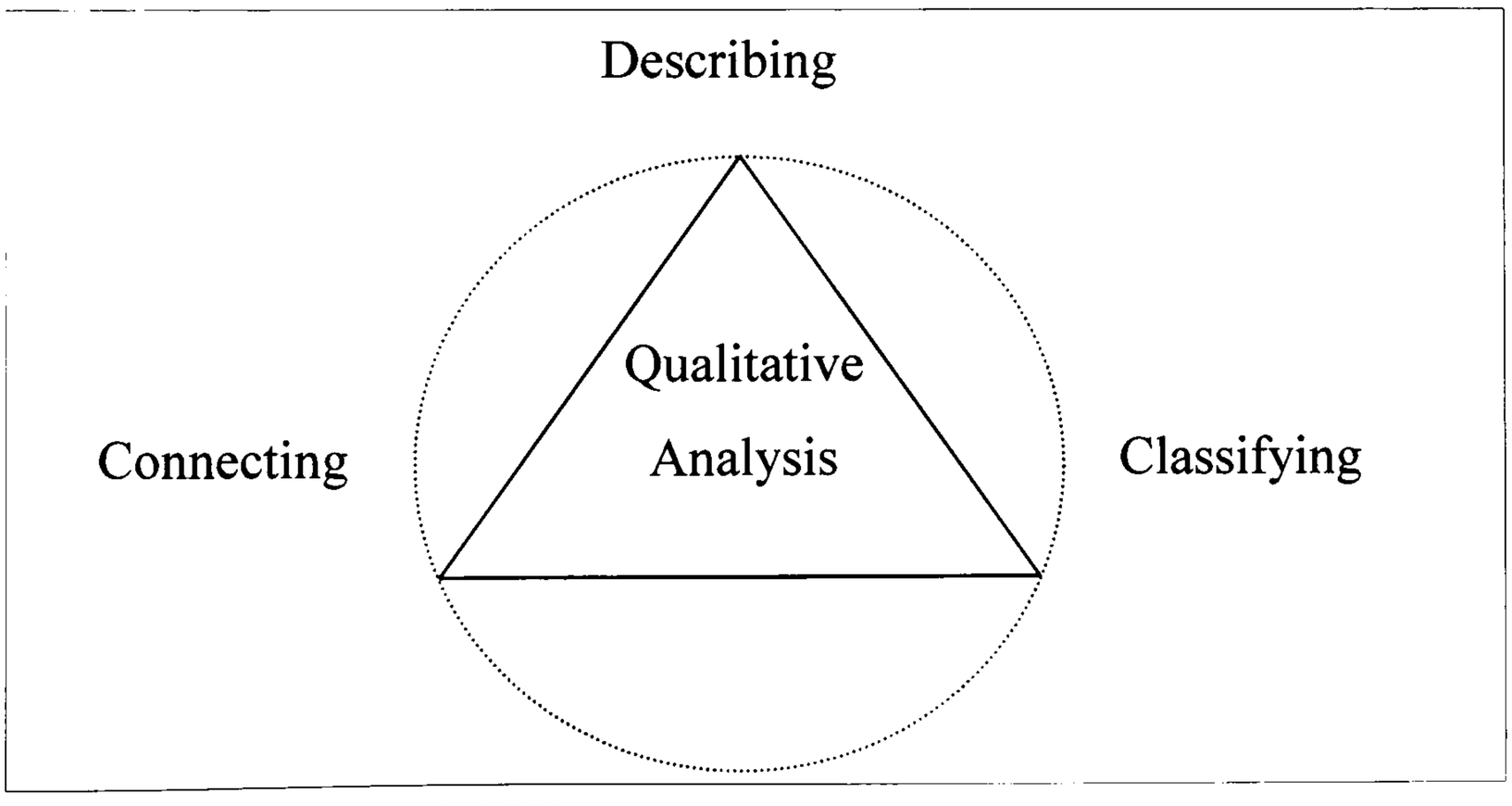
In order to understand the significance of giving attention for various measures to establish reliability and validity of content analysis, experience and arguments of many authors is used. Among the benefits obtained from the papers which use the content analysis are the guidelines to select the unit of analysis, coding decision rules, examples of coding, type of data analysis and so on (Harried, 1972; Aronoff, 1975; Kassarjian, 1977; Jauch, Osborn and Martin, 1980; Ingram and Frazier, 1983; Weber, 1990; Hackson and Milne, 1996; Smith and Taffler, 2000; Ahuvia, 2001; Jun and Cai, 2001; Sydserff and Weetman, 2002; Beattie, McInnes and Fearnley, 2004; Mittermaier, Giorno and Kasimatis, 2005 are a few to mention). Apart from these, several textbooks made a useful contribution in the process of understanding many steps in content analysis (Neuendorf, 2002; Krippendorff, 2004).

Kassarjian (1977:8) explains content analysis as a research technique for the 'Objective, systematic and quantitative description of the manifest content of communication'. Our objective is to design the content analysis framework systematically with the development of decision rules to ensure reliability and validity of the coding process, tabulation of coded data and analysis of data with the theoretical insights from the papers, which have used content analysis. We believe that this approach could lead to avoid the deficiencies in the methodologies in the existing papers identified earlier as well as the avoidance of the criticisms levelled by Huse (2005) and Bourgeois (1979) explained earlier.

The basic model of the content analysis is shown in figure 4.1. Accordingly, classification of a document in to categories for greater understanding, describing the classified categories and analysis of the categories to see the relationship of the categories either as independent or dependent variables of a phenomena are the functions of content analysis. Kassarjian (1977) restricts the content analysis only to manifest variables. Two types of variables could be extracted: manifest variables (denotative meanings), that is the themes appearing in the document and the latent variables (derivable from the manifest variables or connotative meanings) (Ahuvia, 2001). Rauh and Stickel (1996) explain derivable data as follows. 'Derivable data are data which are inferred (or deduced) from other data by applying a derivation rule' (Rauh and Stickel, 1996:135).

Figure 4.1

Content Analysis Design



Source: Gray (2004:328)

4.3.1 Content Analysis - Stability, Reliability and Validity

Concept of stability is discussed first as it is a relevant concept only for the content analysis technique. Kassarjian (1977) explains that if the coding of a document is done in the same way after a period of two weeks, and if the same codes are given for the document coded, the stability is achieved[4]. The development of a coding instrument and decision rules on coding with the understanding of the theory could ensure stability to a greater extent (Weber, 1990).

Reliability is the confidence one can keep on the findings made on a content analysis of a document. In order to rely upon the content analysis, there is a need to ensure that the content analysis is done by the researcher on a set of rules established before the content analysis is undertaken (Milne and Adler, 1999; Jun and Cai, 2001). Accordingly, the decision on the unit of analysis (word, sentence, paragraph, page size and so on), mutual exclusiveness and exhaustiveness in the coding process (if the sentence is selected as the unit of analysis, particular sentence selected for coding is coded only once (mutual exclusiveness) and at the same time ensure that all the sentences are appropriately examined or not to miss out any sentences (mutual exhaustiveness), giving examples of coding, explain the stages of coding and so on are vital steps required to ensure reliability.

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[4] Thayer (1963) points out that a researcher could develop a new way of looking into a concept even overnight from the stance he or she had earlier for the same. However, Inglehart (1997) argues the opposite that '... neither individual's values nor those of a society as a whole are likely to change overnight' (1997:34).

Validity means the categories established in the content analysis have the property of explaining the particular phenomena meant for the analysis. In this research, the role of the NEDs is the objective of understanding through the content analysis of the annual reports. Validity consists of two components namely internal validity and external validity. If the categories established through the coding process are backed by the theory, internal validity is ensured. For example, category of strategy, advice and monitoring and so on are found as tasks of the NEDs (Chapter 2). Therefore, internal validity could be established when there is theory behind the categories.

External validity could be ensured when the content analysis designed is replicated in the same research context or in another research context and if the results obtained are similar or close to the same results (Sutton and Staw, 1995; Whetten, 1989; Bacharach, 1989). However, there is a need to consider the different environments such as the legal, social and economic, cultural and so on (Johns, 2001).

4.3.2 Unit of Analysis and Sample

First, the decision regarding the unit of analysis should be made. Unit could be any of the following: word, sentence or page (Milne and Adler, 1999). These authors point out that the sentence is far more reliable than the word and page size. Stiles (2001:634) writes that 'Sentences which contained reference to the board's involvement in strategy were analysed and key verbs or qualifiers were highlighted to ascertain the mode of involvement'. The decision on the selection of the unit of analysis has to be in the context

of the research and the type of the document (Weber, 1990; Neuendorf, 2002; Kippendorff, 2004). The sentence is selected as the unit of analysis.

Selection of annual reports for coding is guided by the following broader framework: (1) corporate environment where there is implementation of non-regulatory codes on corporate governance (see figure 2.1 in chapter 2), (2) listed companies which have NEDs in their BODs, and (3) methodology designed could be replicable into an emerging corporate sector such as Sri Lanka. The first two of these three parameters could be found only in the UK companies listed in the LSE. However, of the two type of listed companies in the LSE, the FTSE companies are very large in terms of the annual turnover, employment, profit, equity to compare a few with any emerging market (table 3.2 in chapter 3). However, the listed firms in the AIM have more similarities in terms of the size, the rules governing the entry and exit from the trading floor (AIM, 2007a; SEC, 2006), to a corporate sector such as Sri Lanka (chapter 3 – see section on corporate sector too).

For the coding of the annual reports for content analysis, a sample of AIM annual reports is selected. However, the number of annual reports selected as a sample is not a priori decision. As Glasser and Strauss (1967) and Ahuvia (2001) explain, the coder decides the last annual report to be coded when only the coder gets an understanding of the emerging pattern of the data and the picture. This stage is called as the theoretical saturation of the coder (Glaser and Strauss, 1967) or theoretical sensitivity (Ahuvia, 2001). Authors

namely Ahuvia (2001) and Milne and Adler (1999) explain that the researcher should have the theoretical knowledge to gain theoretical saturation.

In order to ensure reliability of coding by a single coder, Milne and Adler (1999) point out that, there are several ways to ensure theoretical sensitivity. 'Researchers can demonstrate that a single coder has undergone a sufficient period of training. The reliability of the coding decisions on a pilot sample could be shown to have reached an acceptable level before the coder is permitted to code the main data set' (Milne and Adler, 1999: 238). Above authors point out the development of the coding instrument (table 4.1) could be considered to show the theoretical knowledge and sensitivity in the subject. Several samples of coding and stages of splitting of sentences are discussed later to comply the arguments of Milne and Adler (1999).

Table 4.1

Coding Instrument

Code	Category	Sentences which have following words or similar words to be included in the code (some examples are given from the coded annual reports)
A	**Advice**	Advice the Board and the management in following aspects
		Structured Board Procedures
		Financial Expertise
		Operational Expertise
		Marketing and Sales
		Management Experience: '*The board is also pleased to announce the appointment of Eric Blakie as a Non-Executive Director. Eric has extensive sales and marketing experience both in the UK and internationally. He was previously with Domnick PLC for 28 years. Being a member of the management team, which led the buyout, and subsequently_listing. While serving as Managing director for each of the main divisions and hence brings significant management experience to Premier Direct Group PLC'* (Premier Direct Group, 2005:4)

M	**Monitoring**	Monitoring of the performance of the managers, the firm, internal control systems
		Monitoring of operational performance *'conducted a six months' review of the company's operations'* (S&U PLC Annual report, 2005:8)
		Development of internal systems, investment in management development, 'We have … invested in our people' (Tenon Group annual report, 2005:2)
S	**Strategy**	Setting goals and objectives with mission and vision, Acquisitions, Development of a new product range, Introduction of new technology, Selling of a subsidiary, Long term planning sessions, Floating of the company, Preparation for an Initial Public Offer (IPO), Joint venture agreement , diversification, Joint venture agreement,
		Strategy contribution: Participation in long term planning sessions,
		Strategic information: Information on competitors, Information on substantial shareholdings of the company
		Strategy review and selection: acquisitions, selling of a subsidiary,

		Example: *'The directors intend to change the company's stock exchange listing from the London Stock exchange main market to the Alternative Investment Market'* (Annual report of Park Group PLC (2005:5) *'The board has a clear strategy to develop the group business by delivering organic growth ... by making complementary acquisitions'*(Sanderson Group PLC, 2005, 30:1)
		Strategic thinking: Innovation
BAP	**Board Approvals**	Approval for the appointments of a director, CEO, company secretary, auditors and related administrative matters, approval of reports
		Terms of engagement, remuneration
		Approval of reports
		Approval of budgets, terms of reference,
		Approval of Investments, divestments, acquisitions
		Strategy 'All strategic decisions are refereed for the board for approval' (Albernaries and Bond, 2006: 28)
		Allocation of shares
BAUT	**Board Authority**	Exercise of authority or seek authority for following
		Remuneration of Auditors

	.	Allocation of Shares
		Repurchase of Shares
		Tender offers
		Borrowing powers
BBEL	**Board Beliefs**	Beliefs about the future, financial strength, strategic focus of the firm, market growth, abilities of directors and employees
BCOM	**Board Communications**	With trade unions of employees, shareholders, financial news media, regulators etc.
BCON	**Board Considerations**	Consideration on going concern, compliance, listing in the main board, nature of independence of NEDs
		Board considers that the NEDs are independent
		Board considers that there is *'Adequacy of organisation structure'*(LPA, 2006:10)
		Annual report presents a balanced and understandable assessment
		Company Law relating to accounting and auditing has been applied
		There is no need at present to have an internal audit function
		Board considers that the balance of relevant experience amongst the various board members enables the

		board to exercise effective leadership and control of the group
BCRI	**Board Criteria**	Guidelines for any of the following activities: preparation or revision in advising, participating in the tasks
		Remuneration, bonuses, share options
		Treasury policy, investment guidelines, operational guidelines, manuals
		Terms of reference for directors, evaluation of directors
		Safety and environment
BDEC	**Board Decisions**	Capital structure decisions, capital investments,
		Remuneration of directors
		Repurchase of shares
		Gearing
		Removal of company secretary *'Approval or removal of the Company Secretary is a Board decision'* (Lonmin PLC, 2005:11)
		Tender offer
		Pre-Emption Rights

		Share issues
		Appointment of directors
		Dividends paid
BDEL	**Board Delegation**	To management and to executive directors
		To investment manager
		To committees
BEVA	**Evaluation**	Evaluation of the performance of the directors, sub committees, top management
		Board Evaluation by Board *'The Board undertakes an annual evaluation of the Chairman, the board and each of the Board Committees but not of individual directors'* (Radstone Technology PLC, 2005:23)
BIS	**Board Input Sources**	Sources of the information for the Board: Request for reports and studying for decisions
		Executive directors' reports
		Strategy, budgets, annual reports, interim reports
		Analysts reports, Broker reports
		Sub committee reports (Audit, remuneration, nomination)

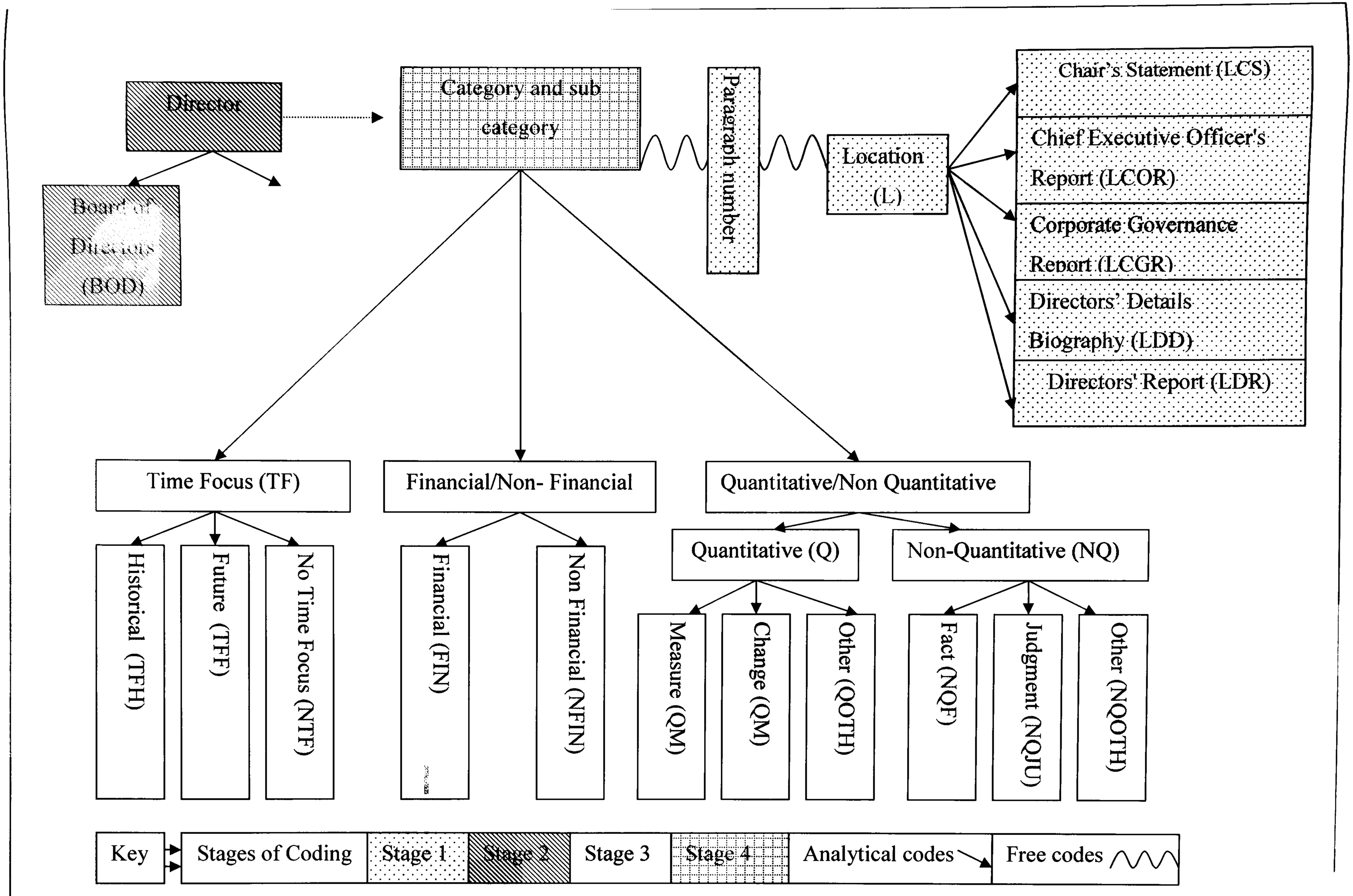
		Institutional shareholders
		Independent professional advice
		External auditor papers
BLED	**Board Leadership**	Leading the board and management: Give entrepreneurship to the firm
BMEE	**Board Meetings**	Monthly, Bi Annual, annual or ad hoc meetings: Among the Board itself, With executives, Sub Committee meetings
BOBJ	**Board Objectives**	Objectives set by the board for the board: Create value for shareholders, Provide leadership, Strategic objectives, Allocation of resources
BORG	**Board Organisation**	Organising the Board: Structure, separation of authority between chairman and CEO
		Restructure: Restructuring of the Board *'During the year, we have restructured the Board of Directors BOD to reflect it's public company status'* Reneuron, 2006:3)
		Formation of sub committees
BPRO	**Board Proposals**	Proposals to remove the restrictions on company borrowing powers

BRED	**Board Recommendations**	Dividends, recommendation for the approval of shareholders (dividends, pre-emption rights)
BRES	**Board Responsibilities**	Various responsibilities of the board which ensure efficient and effective Internal Control System
		Remuneration of directors
		Accounting policy, Accounting standards
		Financial statements, Accounting Records
		Safeguard Assets
		Judgments and estimates
		Social responsibilities
		Fraud and irregularities
		Strategy
		Budgets
		Web site
		Financial performance

BREV	**Board Revisions/Reviews**	Revision of budgets, strategy, terms of reference of appointments
SMRB	**Scheduling Matters Reserved for Board**	Scheduling the tasks reserved for board, review of necessary changes (strategy, acquisition policy, capital expenditure, budgets approval, treasury)
BNEG	**Board Negotiations**	With trade unions, government officials, foreign countries
BEXP	**Board expectations**	About future market growth, regulatory developments
BANN	**Board Announcements**	Tender offers, changes in management, ownership

4.3.3 Mutual Exclusiveness and Exhaustiveness

In order to ensure two properties in content analysis namely, mutual exhaustiveness and exclusiveness (Weber, 1990; Kassarjian, 1977), the structure of the data file has a column to mention the location of the particular sentence and the paragraph number (see figure 4.2 - stages of coding). Data entry as mentioned above could ensure that each sentence coded is entered in the data base carefully. Further, attention of the coder to ensure mutual exhaustiveness and mutual exclusiveness could be ensured, that is each sentence is read and distinguished from the other, and if coded a sentence could fall only into one of the codes in the coding instrument. For instance, a sentence could not be categorised into two as strategy and monitoring. It could go only either as strategy or monitoring. If there is an ambiguity of making a choice of the best code or if there is no code at present (Table 4.1 coding instrument), it is required to find literature again as did by Perry and Bodkin (2000) in the coding process to give a code.


Director
Board of Directors (BOD)
Category and sub category
Paragraph number
Location (L)
Chair's Statement (LCS)
Chief Executive Officer's Report (LCOR)
Corporate Governance Report (LCGR)
Directors' Details Biography (LDD)
Directors' Report (LDR)
Time Focus (TF)
Financial/Non- Financial
Quantitative/Non Quantitative
Historical (TFH)
Future (TFF)
No Time Focus (NTF)
Financial (FIN)
Non Financial (NFIN)
Quantitative (Q)
Non-Quantitative (NQ)
Measure (QM)
Change (QM)
Other (QOTH)
Fact (NQF)
Judgment (NQJU)
Other (NQOTH)
Key
Stages of Coding
Stage 1
Stage 2
Stage 3
Stage 4
Analytical codes
Free codes

4.3.4 Location of the Sentences

Berg (2004) emphasises the need to look across the document to identify the themes needed for the analysis. 'Because themes may be located in a variety of places in most written documents, it becomes necessary to specify (in advance) which places will be searched' (Berg, 2004:273). Accordingly, the unit of analysis, the sentence 'location in report' (Milne and Adler, 1999:241), i.e. in the annual report could be in many places namely, in Chair's statement, CEOs review, corporate governance report, directors' details and directors' report (figure 4.2). These sections will be included for coding and codes are given in the data structure to identify the location of the particular sentence (see figure 4.2).

4.3.5 Theoretical Framework for Coding Instrument

In chapter 2, the role of the NEDs was discussed as explained in the academic and prescriptive literature such as the Cadbury (1992) and in the Combined Code (FRC, 2006). Table 4.1 shows the coding instrument, which has benefitted from the theory discussed in chapter 2. Apart from the terms derived from the theory, identifying themes, which appear in many annual reports of AIM companies, needed to be considered as unique and accordingly the open coding stage is constructed using Grounded Research Methodology (Glaser and Strauss, 1967). However, in order to ensure theoretical sensitivity (Ahuvia, 2001), these themes in the open coding stage is further put into see whether there is any theory behind (Perry and Bodkin, 2000). The terms such as

negotiations, consensus and beliefs are some themes in the open stage of coding resulted purely by the examination of the annual reports of AIM companies but found later to have a rich theory behind. Few of these concepts are explained below.

The theme, 'negotiation' is a task of the management and the BOD which arises when they attempt to take resources to the corporations. D'Aveni and Kesner (1993:126) write that 'Numerous board connections of top managers (and other elite connections) may also be a means by which organizations negotiate their environments'. Zahra and Pearce (1989) point out five elements in the board process, i.e. the frequency and length of meetings, CEO-board interface, level of consensus among directors on issues at hand, formality of board proceedings, and the extent to which the board is involved in evaluating itself. Therefore, consensus is a vital element to be found in the annual reports. It is a vital process variable in the boardroom where there is a culture of working together with more interactions among the members (Pettigrew and McNulty, 1995).

Another two themes which appear in the annual reports of AIM companies are the beliefs and the criteria which have a theory behind as explained below. Beliefs make a vital function among many stakeholders in large organisations (Steiner and Edmunds, 1979). Beliefs created among the minds of the stakeholders by the BOD or the management are the most important other than the beliefs coming from generation to generation such as myths. Gist (1987) explains that the beliefs guide many actions such as recruitment, setting of goals for the corporation and motivation of employees. Beliefs are one of the decisive factors of job satisfaction (Brief and Aldag, 1981). Development of criteria to

evaluate the BOD, performance of the firm, recruitment of the directors is vital to protect interests of the stakeholders as explained by Useem (2003) who point out the lack of such criteria in the failed giant corporations in the US.

4.3.6 Coding Decision Rules

Milne and Adler (1999) and Beattie, McInnes and Fearnley (2004) point out the need to develop coding rules in order to make the coding instrument as well as the coding process itself reliable and validate. Decision rules explained below could be included into a codebook which is useful for a large scale of content analysis using number of coders (Mittermaier, Giorno and Kasimatis, 2005). Codebook is useful to inform the coders, the objectives of coding, coding rules, documents used for coding and so on. Following decision rules are developed for the coding process of the annual reports of the AIM companies:

(1) Objectives

The objectives are to identify the role of the NEDs with a systematic approach and thus to develop the research methodology to ensure replication with reliability and validity of the content analysis.

(2) Selection of annual reports

(a) Annual reports of AIM companies are chosen for content analysis.

(b) The identification of the company whether it is an AIM market or a listed company in the main market needs to be done. It is required to go through the following pages of an annual report that is company information, chairman's

statement, corporate governance report and directors' report because there is no standard practice for some of the disclosures of annual reports. If the locations do not have a clue to identify whether the annual report is an AIM company report, the next location is to see the list of advisors of the company. If the company has nominated advisors and the brokers, the annual report belongs to AIM because each AIM is required to have them to liaise with the LSE.

(3) Coding process - basic rules, specific rules and exclusion rules

Basic rules of coding are as follows:

(a) Unit of analysis is the sentence.

(b) Contribution of the BOD or NEDs could be stated in the following locations in an annual report: (a) Chairman's statement; (b) Chief Executive Officer's report; (c) Corporate Governance report; (d) Directors'details or biographies report and (e) Directors' report. Standard reports such as auditors report and the financial statements are excluded. Within the corporate governance report, the sections exclusively report on the work of sub committees of the NEDs, that is audit, nomination and remuneration or any other committees would also be excluded as they have a specific task with a term of reference.

(c) The paragraph number and the location of the sentence is entered in the database in order to enable constant comparison going backward and forward in annual report to ensure mutual exclusiveness and exhaustiveness discussed earlier.

(d) Figure 4.1 shows the stages of coding and the codes used for each attribute.

Specific rules are as follows:

(a) Does the sentence mention the words Non Executive Directors (NEDs)?

(b) Does it have an identifiable outcome and who claim it? NED or BOD?

(c) If the word NED does not appear, does the word 'Board' or the phrase 'Board of Directors' appear?

(d) If the above criteria fulfils, does the BOD has NEDs? In UK PLCs there is a unitary board.

(e) If the identifiable outcome does not appear in the same sentence along with the words 'Board' or Board of Directors or Non-Executive Directors, does it appear in another paragraph?

(f) Does the paragraph, which denotes an outcome is identified as above, could it be linked as a claim of the NEDs or BOD?

(g) Which attributes are displayed in the sentence which have an outcome, i.e. time focus, financial/non financial, quantifiable or non-quantifiable (Figure 4.2)

Exclusion rules on coding are as follows:

(a) Sentences which start with the words 'We' and 'Our' in Chairman's statement and CEO's statement will be not taken as a claim by either the NEDs or the 'Board'. Top management which include NEDs take decisions jointly (Hambrick and Mason, 1984). It could be further screened by identifying whether the words 'We' or 'Our' are refereed to the present 'Board' or the NEDs. Therefore, the context of the sentence must be evaluated (Johns, 2001).

(b) Within most of the annual reports and within the Corporate Governance report and the directors' report, the statutory responsibilities of the directors as per the Companies Act (2006) is mentioned and it is a standard inclusion. If the sentences say anything other than these statutory responsibilities such as the maintenance of

the web site, it will be included as a contribution of the directors subject to the decision rules.

4.3.7 Coding Examples

Some authors give examples of coding in their respective content analyses (Jauch, Osborn and Martin, 1980; Milne and Adler, 1999; Mittermaier, Giorno and Kasimatis, 2005). Following examples are given to make the coding process reliable and validate as well as replicable apart from giving the opportunity of learning the coding process by a novice coder.

Example (1) (Codes in bold are from the codes in figure 4.2 and table 4.1 and the underlined themes or the part of the sentences should get the attention in coding)

(LDD) 'Fican Coombs *(Non-executive director)* **(NED)**: *An Economic Analyst. He has conducted* **(TFH)** *a six month* **(QOTH)** *review of the company's operations'* **(M, NFIN)** (S&U PLC Annual report, 2005:8).

Codes used: **(LDD)** Location of the sentence (directors' biographies page), **(NED)** Non-Executive Director, **(TFH)** Time focus historical, **(NFIN)** Non financial, Quantitative other **(QOTH), (M)** Monitoring operational review.

Decision rules for coding are decided in answering the questions below.

(a) Where does the sentence is located? Biographies of the Directors **LDD**

(b) Is the director a NED? Yes, **NED**

(c) Who claim the contribution? **NED**

(d) What is the outcome? Review of the company's operations **M**

(e) What is the time dimension? Historical **TFH**

(f) Is it financial or non-financial? Non-financial **NFIN**

(g) Is it quantifiable? Yes, Other: Six months of review **TFH, QOTH**

(h) To which category, this contribution belongs? **M**

Example (2): Linking two paragraphs (Beattie, McInnes and Fearnley, 2004)

The first paragraph of the chair's statement of the annual report of Nautical Petroleum PLC (2006:2) which has two sentences is as follows.

(LCS) *'The company has made* **(TFH)** *very substantial progress since listing on the Alternative Investment Market in April 2005* **(QOTH).** *In the process, Nautical has achieved widespread recognition* **(NQJU)** *as a focused and specialist heavy oil development and production company, which now holds a significant portfolio of reserves, contingent resources* **(FIN, QOTH)** and *prospect'*. **(TFF)**

There is no mention about the directors' role in the above sentence. It appears only in the second sentence in the ninth paragraph. Therefore, the sentence is qualified for coding. Explaining about the progress of the company, it writes:

(LCS) *'This would not have been possible* **(TFH)** *without the determination and dedication* **(CON)** *of the executive management, as well as* **(CONSEN)** *the valued advice and support* **(A)** *of the non-executive directors'* **(NED)** (Nautical Petroleum PLC, 2006:2).

Decision for coding is decided by the following questions and answers.

(a) Where does the sentence is located? Chair's statement **LCS**

(b) Are the directors NEDs? Yes, **NED**

(c) Who claim the contribution? Executive management and **NED**s

(d) What does it mean when it is claimed by executives and NEDs? Consensus in decisions and cooperation **CON, CONSEN**

(e) What are the outcomes? Substantial progress, widespread recognition, significant portfolio of reserves, contingent resources and prospects

(f) What is the time dimension? Historical achievements with prospects for future **TFH** and **TFF**

(g) Is it financial or non-financial? Financial **FIN**

(h) Is it quantifiable? Yes, Other **QOTH**

(i) To which category, this contribution belongs? Advice and support **A**

Codes used: (TFH) Time Orientation Historical, **QOTH** Quantitative Other, **NQJU** Non Quantitative judgement, **FIN** Financial, **TFF** Time Focus Future, **CON** Confidence, **CONSEN** Consensus on confidence, **NED** Non Executive director **A** Advice and support

Example (3) The attribution of related incidents in another page and also with the BOD

(LCS) *'Directors* **(BOD)** *have implemented* **(TFH)** *certain changes to the way the business is operated throughout the year. These changes are expected to deliver ongoing commercial benefits* **(NQJU)**. *In common with many leading UK direct sales operations* **(S)**, *Premier Direct Group Plc has migrated from a commission based agent model to a buy/seller distributor model'* **(SF)** (Premier Direct Group Plc, 2005: 3).

(a) Where is the location? Chair's statement **LCS**

(b) Who has introduced? Board of directors **BOD**

(c) When was implemented? Already implemented **TFH**

(d) Are expected outcomes quantifiable? No. **(NQJU)**

(e) What is the nature of change? A Business Model (**S)**

(f) What are the factors considered in the change? Go with the other firms **(S)**

'The board **(BOD)** *recognised the implications of the new trading model* **(SR)** *in terms of the increased working capital requirements* **(FIN)**. *At 31 July 2005, the Group had available in excess of £3,254,000 of unutilised banking facilities* **(FIN, QM)** *to fund future capital needs* **(TFF)**' (Premier Direct Group Plc, 2005: 5).

(a) Who has reviewed the changes in the business model? **BOD**

(b) What was reviewed? Implications of the model: Strategic review **SR**

(c) What was focused? The ability to find working capital requirements **FIN**

(d) Is it quantifiable? Yes. £3,254,000 of unutilised banking facilities **FIN, QM**

(e) Does the Board look for future? Yes. Fund future capital needs **TFF**

4.3.8 Stages of the Splitting of Sentences

Beattie, McInnes and Fearnley (2004) explain several stages in the splitting of a sentence in the process of coding. It is modified to suit our needs, as they are not taking into account the location of the sentence and the claim of the sentence that is whether the sentence is about the role of the NEDs or the BOD. These two aspects are needed for us to see the role of NEDs separately and to see their action within the unitary system of the board in the UK (Conyon and Muldoon, 2006). The need to ensure mutual exclusiveness and exhaustiveness was pointed out earlier and thus the 'location in report' (Milne and Adler, 1992:241) of the annual report is required to be entered. Following these attributes, coding is done in four stages (see figure 4.2). they are: Location of the sentence (stage 1), claim of the outcome in the sentence by the BOD or the NED (stage 2), attributes namely, time focus, financial/non-financial orientation, quantitative/non-quantitative orientation (stage 3), and category and sub category (stage 4). Examples of coding in stages are given in tables 4.2 to 4.5.

Stages of Coding: Example (1)

Sentence	**(LCS)** *'The board is also pleased to announce the appointment of Eric Blakie as a Non-Executive Director* ***(NED).*** *Eric has extensive sales and marketing experience both in the UK and internationally. He was previously with Domnick PLC for 28 years. Being a member of the management team, which led the buyout, and subsequently listing. While serving as Managing director for each of the main divisions and hence brings* **(TFF)** *significant (***NQJU***) management experience* **(NFIN, AME***) to Premier Direct Group PLC'*. (2005:4) annual report)	
Coding stage	**Description**	**Code in bold**
1	Location L	Chairman's statement **LCS**
2	Claim BOD or NED	Non Executive Director **NED**
3	Time Focus	Future **TFF**
3	Financial/Non financial orientation	Non Financial **NFIN**
3	Quantitative/Non-quantitative	Non quantitative judgment **NQJU**
4	Category and sub category	Advice, Management Experience **A**

Stages of Coding: Example (2)

Sentence	*'Mr X and Y (NED names) ... two independent non-executive directors* ***(NED)*** *have formed a committee to look after* ***(TFF)*** *the interests of third party shareholders'* **(NFIN, MSI)** (Park Group PLC, 2005)	
Coding Stage	**Description**	**Code in bold**
1	Location	**LCS**
2	claim	**NED**
3	Time Focus	**TFF**
3	Financial/Non financial	**NFIN**
3	Quantitative/Non-quantitative	**NQOTH**
4	Category and sub category	Monitoring shareholder interests **M**

Table 4.4

Stages of Coding: Example (3)

Sentence	*'Prospectus for the longer term are healthy and the directors* **(BOD)** *are confident* **(CONSEN)** *of further significant profit growth'* **(TFF, FIN, NQJU)**(S and U PLC, 2005)	
Coding stage	**Description**	**Code in bold**
1	Location	**LCS**
2	Claim	**BOD**
3	Time Focus	**TFF**
3	Financial	**FIN**
3	Quantitative/Non-	**NQJU**
4	Category and sub category	Confidence of consensus **CONSEN**

4.3.9 Data Tabulation

For tabulation of data, the alpha codes are given numerical values in the spreadsheet when they are entered. For example, the location of the sentence is coded as follows: (number within the parenthesis denotes the numerical code) chairman's statement (1), CEO's report; (2) corporate governance report; (3) directors' biography or director details' report and (4) directors' report (5). The numerical values simply transform the alpha codes in figure 4.2 for analytical purposes (For example, Chair (LCS = 1), Chief Executive Officers Report (LCOR = 2), Corporate Governance Report (LCGR = 3), Directors Details/Biographies (LDD = 4) and Directors Report (LDR = 5) – Each alpha code starts with L, denoting the location).

4.3.10 Labelling of Categories Identified as Unique

If there is a significant number of coded categories which could be identified as dimensions[5] of a role which could be identified as different from the existing typologies such as advice, strategy and service, discussed in chapter 2 under the role of NEDs, labelling the new category is required. Labelling a category could be done in two ways either by the 'Pool of concepts already discovered in data' (Strauss and Corbin, 1998:114) or by literature, i.e. 'Established analytic meanings' (Strauss and Corbin, 1998:115). For example, The Handbook of the Directors (IOD, 1995) explains 16 tasks of

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[5] 'A dimension is an aspect of a culture that can be measured relative to other cultures' (Hofstede and Hofstede, 2005:23).

the directors of FTSE corporations and these are divided into 4 main categories using the established meanings in the literature. They are: (1) vision, mission and values, (2) strategy and structure, (3) supervision of management and (4) responsibility to shareholders and other stakeholders.

Accordingly, if there are dimensions which are different to the dimensions of the existing types of roles of NEDs such as advice, strategy and service, (earlier, we pointed out in the review of the methodologies that the dimensions of these roles are not clearly pointed out by the authors (see Pye and Camm, 2003 for example), it is required to put a label using the discovered data itself. Thus, new labels could be introduced as hither to not found roles of the NEDs. In the review of the research methodologies into the role of NEDs, it was pointed out that several authors introduce several categories of NEDs (Stiles, 2001; Pye and Camm, 2003; Heuvel, Gils and Voordeckers, 2006).

4.3.11 Analysis and Discussion of Coded Data

Many authors prepare only the frequency tables for the analysis of coded data (Farrell and Cobbin, 1996; Perry and Bodkin, 2000, Jun and Cai, 2001, Harris and Attour, 2003; Beattie, McInnes and Fearnley 2004). These authors do not test any hypotheses unlike Milne and Adler (1999) who analyse the relationship of the experience and the coding results, taking into two coders (experienced and inexperienced coder). Smith and Taffler (2000) too analyse the relationship between the type of words and themes used in the annual reports and the potentiality of forecasting of company failures. Berg (2004:283)

points out that 'rough hypotheses' based on observation of data could be used to see relationship of variables. Cross tabulations of data (chapter 5) with the development of contingency tables (Rose and Sullivan, 1998) could support the development of rough hypotheses.

The categorical data produced by the content analysis could be analysed with the Chi Square test (Agresti, 1990; Cooper and Schindler, 2003). The Chi-Square test statistics is an overall measure of how close the observed frequencies are to the expected frequencies. Therefore, it is explained as the goodness-of-fit. The expected frequencies are a theoretical distribution. Accordingly, each category emerges in its own way rather than getting disturbed by the emergence of another category. In other words, the distribution of the expected frequencies of the categories reflects an independent and unbiased outcome. Therefore, the expected frequencies are a probabilistic distribution[6].

Number of prerequisites are required in order to calculate the Chi Square test statistics (Agresti, 1990; Cooper and Schindler, 2003): (1) sample must be randomly drawn from the population; (2) frequency values of the categories must be mutually exclusive and exhaustive; (3) data must be reported in frequencies not in percentages; (4) there should not be any cells with zero frequency and (5) expected frequencies below five should not compose more than 20 per cent of the cells (If the frequency is less than one in a two by two table, the Yate's Correction factor is applied and as the content analysis in this research has a large table, this is not discussed (see: Cooper and Schindler, 2003).

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[6] Theoretical distribution ensures the outcome of the experiment on the concept of probability (Cooper and Schindler, 2003).

As we have a large number of categories, we follow the argument of Muhr (1991) to treat the insignificant frequencies of some categories in the content analysis. Muhr (1991:358) suggests the following action. 'Codes and memos that have already been delineated can be renamed, deleted, uncoupled from codes or redefined by simply reselecting them' (Muhr, 1991:358). However, uncoupling or collapsing of the categories has to be done seriously in order to avoid any loss of the significance of the data. The removal of the less frequent categories ensure the application of the Chi Square test but could damage the picture to emerge but the impact could not be so serious since only a few number of data is lost as a result. The overall picture could be explained descriptively as done by many authors (Farrell and Cobbin, 1996; Perry and Bodkin, 2000; Jun and Cai, 2001; Stiles, 2001; Harris and Attour, 2003; Beattie, McInnes and Fearnley, 2004).

The formula for Chi Square: $x^2 = \sum_i \sum_j \frac{(O_{ij} - E_{ij})^2}{E_{ij}}$ (Cooper and Schindler, 2003)

Oij is the observed frequency and Eij is the expected frequency for the cell corresponding to the i^{th} condition and the j^{th} group. The expected value for each cell is calculated by multiplying the two marginal totals common to a particular cell and dividing this value by the size of the sample.

Following steps are taken to analyse the Chi Square calculated values.

1. State the null hypothesis and the alternative hypothesis as follows.

Ho: O = E means the observed value (O) is equal to the expected value (E). The categories are independent. In other words, they have a random distribution.

H1: O ≠ E means the observed values do not equal to the expected value. There could be significant differences or they are dependent.

2. Set the confidence level at 95 per cent (see Rose and Sullivan, 1998).

$\alpha = .05$

3. Calculate the value of the appropriate statistic. Also, indicate the degrees of freedom for the statistical test if necessary.

4. Write the decision rule for rejecting the null hypothesis.

Reject H_0 if $\chi^2 \geq$ table value

The null hypothesis of independence is rejected if the calculated χ^2 is greater than table value (see appendix 2 - statistical table of Chi Square values), because this means that observed frequencies and expected frequencies are far apart. We reject H_0 if the test statistic calculated from the sample lies under the rejection region of the Chi-Square curve with (r-1)(c-1) degrees of freedom.

The Chi Square test unlike the directional tests such as the analysis of correlation of two variables, i.e. independent and dependent (for example, analysing the relationship between the expenses on advertising and sales in a period), it does not attempt to measure the relationship of the categories but the independence.

There are number of tests we could calculate to see the association of the variables (Cooper and Schindler, 2003): (1) Phi coefficient (Φ) and the Cramer's V test are two of them. The step of calculation is as follows. First, the Chi Square statistic value is computed. This value is divided by the number of total sentences. The square root of the above value is taken as the Phi coefficient (Φ).

$$\text{Phi coefficient } (\Phi) = \sqrt{\chi^2 / N}$$

For larger tables, Cramer's V test is done which is a modification of the Phi. The formula is as follows.

$$V = \sqrt{\chi^2 / N(k-1)}$$

K is the lesser number of rows or columns.

Cooper and Schindler (2003) point out that if there is a significant difference between the observed and expected values, that is residual values, the identification of the cells, which contribute for the difference, is required. Residual values have frequency values for each residual value and have a normal distribution. Therefore, the residual values could be standardised with Z score. However, this test is required if only the Chi statistics calculated show a significant difference between the observed values and the expected values (Cooper and Schindler, 2003).

Content analysis data are discussed as per the arguments of the following authors namely Daft and Wiginton (1976) and Stiles (2001). Daft and Wiginton (1979) explain that in communicating research results especially in organisational studies such as the role of

NEDs, the best way to do is description. According to them, description means less use of symbols and formulas as used in Statistics and Mathematics. They explain the style of language used in these disciplines as low variety language. More descriptive studies use more words than symbols, explained as high variety language according to them. Neilsen and Rao (1987) and Folger and Turillo (1999) use the term *thick descriptions* for the above style. Authors cited earlier, namely Farrell and Cobbin (1996), Perry and Bodkin (2000), Jun and Cai (2001), Harris and Attour (2003) and Beattie, McInnes and Fearnley (2004) communicate their research results with descriptive analysis using frequency analysis.

Second, many authors who have used interview method cite excerpts from their interviews in communicating their research results (Pettigrew and McNulty, 1995; Roberts, McNulty and Stiles, 2005; O'Higgins, 2002). Accordingly, in the discussion of the content analysis data too, excerpts from the annual reports would be taken to illustrate points of discussion. In the mixed methods of research, Stiles (2001) use postal questionnaire results to support interview data. Ruigrok, Peck and Keller (2006) use the postal questionnaire results along with the data obtained from the annual reports to discuss the results. Therefore, in discussion of the content analysis data, postal survey results too will be taken into the context.

4.3.12 Collection of Back Ground Data - Content Analysis Schedule

In order to understand the nature of implementation of the non-regulatory codes on corporate governance in the AIM companies, annual reports coded are used. Many authors use annual reports to find out the extent of implementation of the codes on corporate governance in listed companies (Dahya, McConnell and Travlos, 2002; Pass, 2004 to name a few: see Chapter 2). However, their technique of getting the data from annual reports is not clear. We use the 'content analysis schedule' (Jauch, Osborn and Martinm (1980:524-525). These authors prepare a series of questions in order to extract data from the documents they analysed. Similarly, we prepare a number of questions (see Table 4.5) to identify the internal corporate governance mechanisms from the annual reports coded.

Table 4.5

Content analysis schedule – identification of corporate governance variables

No	Question	Location in the Annual report
1	Is the company an AIM listed or main board listed company?	Many annual reports do not mention within the corporate information page whether it is an AIM company. If there is mention about nominated advisors and brokers i.e. two essential coordinators of the AIM with the London Stock Exchange, then it is an AIM company. Read Chair's statement, corporate governance report also if the above locations do not mention about the company status.
2	How many directors are in the company?	Bibliography page of the BOD or the Directors' report (Directors' report is a document required legally (Company Law Act, 2006)
3	How many of them are NEDs?	Bibliography page of the BOD or the Directors' report
4	What is the title of the Chair?	Chair's statement but it is required to see the Bibliography page of BOD also because in some annual reports, Chair's statement mentions as Chairman but within the Bibliography page of the BOD as Non Executive Chairman

5	How many sub committees of the BOD operate?	Corporate governance report but in some annual reports which have no corporate governance report, it appears within the report of the directors'. Also note that the corporate governance report unlike in the FTSE companies, do not appear separately in some AIM companies but inside the directors' report, a mini report on corporate governance.
6	Is there a senior independent director?	Bibliography page of the BOD or the Directors' report

4.4 Administration of Postal Questionnaire and Data Analysis

Many authors (Stiles, 2001; Ruigrok, Peck and Keller, 2006; Heuvel, Gils and Voordeckers, 2006), use postal survey data to support their findings in principal methods of research data in their research projects. This step fulfils the argument of many authors to use triangulation of research methods into the analysis of the role of directors (Stiles and Taylor, 2001; Roberts, McNulty and Stiles, 2005).

In order to ensure reliability and validity of the survey results, questionnaire (appendix 1) is prepared getting the theoretical insights from the papers (Cicourel, 1969; Denscombe, 2003; Gray, 2004; Walliman, 2005). Each item in the questionnaire item is linked to a theory discussed in Chapter 2. Linking the question items with the theory assures validity and reliability of the questionnaire (Bacharach, 1989; Weick, 1989; Sutton and Staw, 1995). Walliman (2005) points out that the linking of the questionnaire items with the theory is an alternative to make a pilot test of a questionnaire. Next, sequencing of questions from a broader framework to a focused area is emphasised (Reynolds, 1971). Simple language or the 'common sense constructs' (Cicourel, 1969:61) is used in wording the sentences in the questionnaire.

Authors have found various dimensions which increase the response rate for questionnaires such as the structure (Dunn, Jordan and Croft, 2003), incentives for responses (Puffer, *et el.,* 2004), and the need to protect anonymity (Campbell and Waters, 1990). Questionnaire has box ticking questions as Gray (2004) argues that the CEOs are

familiar with box ticking than writing. Questions are placed from the respondent's point of view (Gray, 2004).

Questionnaire focuses on the role of the NEDs. The contribution expected by the CEOs, what capabilities are expected of them and how they are evaluated and the attitudes of the CEOs, that is towards the appointment of the NEDs, evaluation, and getting NED positions by the CEOs and so on are covered in part A. Part B has several demographic variables (Hambrick and Mason, 1984) relating to the respondent CEOs as there could be variations in replies due to these variables such as age, educational qualifications and organisational attributes such as the nature of the business and age. Asking of the questions related to the contribution, capabilities, evaluation and the attitudes on many aspects of the appointment of the NEDs such as the source, time availability if the CEOs undertake NED roles, etc. give an opportunity to understand the thinking of the CEOs or the 'Cognitive orientations' (Bigley and Wiersema, 2002:707).

Many authors point out the need to look at behavioural aspects rather than the demographic aspects such as the age, composition of the board and they argue that these variables have only an indirect relationship with the performance of the company (see the models: Pearce and Zahra, 1991; Puffer and Weintrop, 1991; Forbes and Milliken, 1999; Stiles, 2001). However, the questionnaire is not aimed at solving a hypothesis but to understand what the CEOs expect as contribution from the NEDs, how they evaluate and what capabilities are considered.

4.4.1 Reasons for Selecting CEO as the Respondent

CEO is one of the major stakeholders or 'role senders' (Rogers and Molnar, 1976:598) to the NEDs as argued through the perspectives of the role theory (Sarbin and Allen, 1968). Due to difficulties of the access to the board room, Forbes and Milliken (1999) point out that the CEO is the best person to explain the performance of the BOD. Many authors suggest that sending a postal questionnaire to a sample of CEOs could generate much data than trying to get interviews with the CEOs who do not wish to allocate their time for non-business matters (Pettigrew, 1992; Starkey, 2002). Forbes and Milliken argue (1999:492-493) that 'Board performance ... may be assessed by asking the CEO … to rate the value and analysis, the board contributes to strategic decisions'. However, the selection of the CEOs as the respondent for the questionnaire is guided by the understanding of the vital role played by the CEOs on corporate decisions and the ability of them to condition the role of the NEDs as explained below.

Many authors document the influence as well as the responsibility of the CEOs in many decision environments in the corporations. Some of them are: (1) decisions on various strategies such as diversification, purchasing, downsizing and turnaround (Papadakis and Barwise, 2002; Datta, Rajagopalan and Zhang, 2003; Papadakis, 2006); (2) decisions on compensation for CEO (Sridharan, 1996); (3) appointment of directors (Higgs, 2003), and (4) the degree of corporation and information sharing with the NEDs (Kakabadse, Kakabadse and Barratt, 2005). Main method of investigating to the role of the CEOs is not the interview method according to the above papers but the development of

hypotheses and testing them with the data obtained from databases. These authors develop hypotheses through the prior literature and develop measures for the variables. For example, the influence of the CEO is measured by the duality, i.e. if the CEO and the chair both are by the same person; it is taken as a dummy variable (Sridharan, 1996).

Filatotchev *et. el.* (2007) point out that the researchers must attempt to understand any potential positive or negative changes in the behaviour of the top management when they are required to implement the regulatory or non-regulatory corporate governance mechanisms. They write: 'Bearing in mind the depth and breadth of the UK regulatory initiatives… to verify whether they were followed by behavioural changes of the participants in corporate governance mechanisms, including unintended consequences such as the development of *gaming practices'* (Filatotchev *et. el.,* 2007:2). Westphal (1998) argues that structural changes such as giving the NEDs wider powers such as the heading of sub committees of the BOD, namely nomination and remuneration committees of the BOD, lead to a loss of power of the CEOs. CEOs re-gain power by impression management (Gardner and Martinko, 1988) displaying their strength through the business contacts, information base and wider knowledge in the business world and thwart the attempts of the NEDs to take upper hand in the management of the corporations.

The decrease of power of the CEO could have a trickle down effect too (Aghion, and Bolton, 1997). When the CEO is powerful, he has resources to dispose at his will and the managers get proportionately and when he is less powerful, he has less to himself and so

the subordinate managers also could get less. Therefore, the CEO centred top management (Pettigrew, 1992) could be reactive. Hermalin (2005) argues that more outsiders would take CEO positions in the future. If perception errors create between the CEO and top management towards the NEDs (Stiles and Taylor, 2001; Hillman and Dalziel, 2003), they could prevent the success of internal and external corporate governance mechanisms (Walsh and Seward, 1990). In this situation, the objective of analysing the role of the NEDs through the perspectives of the CEOs is justifiable.

However, among the papers reviewed above, we have found only a few number of papers getting the CEO as the respondent for the postal questionnaires (Berry and Perren, 2001; Heuvel, Gils and Voordeckers, 2006; Minichilli and Hansen, 2007) and some authors have interviewed CEOs in addition to other methods of research in their papers (Stiles, 2001; Stiles and Taylor, 2001).

4.4.2 Response Rate for Questionnaires

The response rate for the postal questionnaires in the UK and elsewhere is as follows. Ward (1998) had 33 completed questionnaires (43.4 per cent) out of 76 postal questionnaires[7]. Westhead (1999) had received a 47.2 per cent of response from a sample of 905 companies among the medium and small companies in the UK. Stiles (2001) has obtained a response rate of 13.4 per cent out of 900 postal questionnaires with a reminder

[7] O'Sullivan (2000) appreciates this research results due to lack of research in this area although the author says the response rate is not enough.

after two weeks of initial mailing. This questionnaire has been sent through the Institute of Company Secretaries and Administration in the UK. Author writes that the response is low '... but consistent with expectations' (2001:633). Heuvel, Gils and Voordecken (2006) have sent postal questionnaire to 3,400 small firms in the UK with a reminder and the authors obtained 311 completed questionnaires (9.1 per cent). Filatotchev *et al.*, (2007) sent the questionnaire through email linked to a web site opened to get the responses. The responses from 133 authors[8] in corporate governance across the world to identify the *Key Drivers of Good Corporate Governance* (Filatotchev *et al.*, 2007) has resulted a 40 per cent of response according to the authors. In literature review, we have discussed these findings (Chapter 2).

Pearce and Zahra (1991) receive an overall 20 per cent response for the postal questionnaire in a sample of 695 companies in the US (400 manufacturing and 295 service companies in each category of Fortune 500 and a total of 69 manufacturing and 70 service companies responded). Meanwhile, Ruigrok, Peck and Keller (2006) have received a response rate of 28.5 per cent from a sample of 217 companies in Switzerland.

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[8] Filatotchev *et al.*, (2007:80) write of the sources of the sample as follows. 'The team identified 133 corporate governance experts using various sources of information, such as the literature review, corporate governance related web sites and personal contacts.' Authors do not categorise the sample as well as the source of response, i.e. the response rate from personnel contacts, from web sites and from the authors sourced through literature review. If the majority or the full number of response is from a particular source, sample biasness is inevitable leading to the questions of reliability and validity of this research. However, since the authors do not disclose the sampling, there is a difficulty of replicating the study in the same context again and or in another research context.

However, none of these authors mention explicitly of prior expectation of a possible response rate except Stiles (2001) who make an informed guess writing it as '... consistent with expectations' (Stiles, 2001:633). There is no any empirical research to understand the reasons for response by the potential respondents and whether the potential respondent himself or herself responds for the postal questionnaires (Campbell and Waters, 1990; Dunn, Jordan and Croft, 2003; Puffer, *et el.,* 2004). In the context of the above rates of responses for the postal surveys, we keep an open eye on the response rate but as Stiles (2001) did, reminding the respondents after two weeks of mailing will be done in order to increase response rate.

4.4.3 Sampling Framework and Sample

The broader guidelines discussed in section 4.3.2 in relation to the selection of the AIM companies for the content analysis is applicable for the postal survey as well. Sampling for the postal questionnaire is decided by the following in addition to the above broader guidelines. Accordingly, the sample criteria are as follows: (1) UK owned AIM companies and (2) situated within Greater London. In the questionnaire, CEO was asked to mention whether he or she was prepared to give an opportunity to make available for interviewing. Therefore, the above sampling method would be convenient (Gray, 2004) and less cost too in travelling.

The *FAME* database has a comprehensive coverage of the AIM companies, namely, the shareholder funds, employment in companies, financial data such as the turnover, assets,

income and profits and details of the directors[9]. There are 1,068 companies in the AIM market as at February 2007. These companies constitute the sampling frame which is explained as the 'Objective list of the population' (Denscombe, 2003:17) or the 'Wider population or wider universe' (Mason, 1996:85).

4.4.4 Analysis of data

Sample statistics, namely sample average, variance and standard deviation could be used to estimate the population parameters, i.e. average, variance and the standard deviation of a population (see Cooper and Schindler, 2003). Most important population parameter is the average value of a certain phenomena for example the average number of CEOs among the AIM companies who think that the strategy is the most significant contribution required of the NEDs. In a large population of NEDs as in the UK, the population average would not be exactly known for sampling difficulties, expenses to be borne, and the time taken. Therefore, the population average could be estimated to lie between two ranges of the sample mean. In order to estimate the population parameters, we should see the actual response rate. Therefore, if the response rate from the sample is above 30 per cent, it could give an unbiased sample statistics. It can be used to calculate the population

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[9] Data of the UK companies could be obtained from the following too but they do not have AIM data separately. (1) *Companies in 2005-2006* (DTI, 2007), (2) *Key British Enterprises, 2005,* London: Dun and Bradstreet, (3) *Kelly's Industrial Directory*, 2006, (4) *Who Owns Whom, 2006/07*, London: AP Information Services. The fame database is now replaced by Orbis database. Since this change, the AIM data is now not separately available.

average with the confidence level of 95 per cent that it lays between two ranges of values of the sample mean (Cooper and Schindler, 2003).

In evaluating the sample statistics, one should keep in mind the two types of errors called type I error and type II error. In simple meaning, one could reject the null hypothesis when the sample statistics is in the rejection area but when in fact the null hypothesis is correct (type I error). When the null hypothesis is not rejected when in fact it is wrong, type II error occurs. This could happen due to a bias sample however the attempt to make the sampling process systematic and unbiased (Cooper and Schindler, 2003).

4.5 Conclusion

One of the objectives set in Chapter 2 in literature review in general theoretical framework in corporate governance is to construct the research instruments to collect the data. This chapter achieves this objective by constructing the two research instruments namely the content analysis and the postal survey questionnaire. When compared with the research methods used in the existing literature on the role of the NEDs, the research instruments designed for this research has more rigour in terms of the ability to replicate the research in the same research context or another research context. The main reason for this is the absorption of methodological insights from a range of papers across several disciplines which argue the need of backing the research instruments with the theory and complying for the needs of scientific standards. Therefore, the research methodology designed has the criteria applicable for scientific papers (Bacharach, 1989; Sutton and

Staw, 1995). The criteria, such as the decision rules, examples, statistical tests, sampling and so on were discussed in relation to both content analysis and postal survey method.

However, the real test of this could be the execution of the methodology, especially the coding of annual reports and the analysis of the categorical data. Equally important factor is the replication of the research in the same context or another research context to see whether there is a possibility of getting same results. This external validity test is crucial. Then only the internal validity tests discussed in developing the methodology (mainly the content analysis) could be solidified and make reliable. The next chapter analyses the survey data generated from the execution of the research methodology discussed in this chapter.

Chapter V

Survey Data Analysis

5.1 Introduction

Chapter 4 contributed by designing the research instruments namely the coding instrument (table 4.1), content analysis schedule (table 4.6) and the postal questionnaire (see appendix 1) which were used to collect the data analysed in this chapter. Two types of data are collected by these instruments namely nominal data and ratio data[1]. Nominal data and ratio data are analysed as explained in section 4.3.11 and section 4.4.4 in chapter 4. The response rate for the postal survey was 11.3 per cent. As the response rate is below 30 per cent, it does not qualify for parametric tests as discussed in Chapter 4. Therefore, the analysis is done using the frequency of responses for the respective questions in the survey (see postal questionnaire appendix).

5.2 Corporate Governance Variables of Sampled Companies

Content analysis schedule (table 4.6) generated data in relation to the degree of acceptance of corporate governance guidelines by the AIM companies. Accordingly, majority of the companies have followed corporate governance guidelines such as the separation of the role of the chair and the CEO and formation of sub committees of the

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[1] Nominal data are the information collected on a variable that can be grouped into two or more categories which are mutually exclusive and collectively exhaustive. Division of directors as executive and non-executive and categorisation of the tasks of NEDs as in table 4.1 are an example. All the above properties are accompanied by ratio data plus the ability of ratio data to measure a variable to an absolute value or origin (See Cooper and Schindler, 2003).

BOD. Table 5.1 points out that 52 per cent of the companies in the coded annual reports have non-executive chair. However, it is required to note here that the use of the term 'chair' is not so rigorous in some annual reports. For instance, in the statement of the chair, the title is mentioned as chairman and in the bibliography page of the same annual report, it appears as non-executive chair. However, whether the NED chair meets the criteria of independence (Higgs, 2003) could be judged by seeing whether the particular NED chair has shares as well as any interests in the company. By looking at these dimensions, it appears that majority of the NED chairs of AIM companies have shares in the companies they work and not truly independent as the NED chairs of FTSE companies.

Table 5. 1

Type of Chair

Type of Chair*	**Number of firms**	**Per cent**
Chair	19	25.3
Executive Chair	17	22.7
Non-Executive Chair	39	52.0
Total	75	100.0

Source: Survey data

Note: * Chair is referred hereafter as simple chair and Executive Chair as EC Chair both in the text and in the tables in this chapter.

Table 5.2 shows that the audit and remuneration committees are more prevalent (74.7 and 73.3 per cent respectively) while the nomination committees (41.3) are still to develop. There is no clear term of reference for the sub committees as in the FTSE companies. Table 5.2 shows that 26 companies (34.7 per cent) have all three committees and 25 companies (33.3 per cent) have two committees, mainly the audit and the remuneration

committee. At least in 25.3 per cent of companies (19 companies), have no any sub committee in the BOD although there are NEDs.

Table 5.2

Sub Committees of the Board

Committee	**Number of firms**	**Per cent (out of 75)**
Audit	56	74.7
Remuneration	55	73.3
Nomination	31	41.3
All three of above committees	26	34.7
Two committees	25	33.3
Only one committee	5	6.6
No sub committees	19	25.3

Source: Survey data

Table 5.3 shows that many companies appoint the NEDs. Only in 6 companies (8 per cent), there are no NEDs. There are 11 companies which have 1 NED in each (14.7 per cent). There are 24 companies which have 2 NEDs in each of them. There are 3 NEDs in each of 22 companies. In 11 companies, there are 4 NEDs in each of them while in one company, there are 5 NEDs.

Table 5.3

Number of NEDs

Number of NEDs	**Number of firms**	**Per cent**
0	6	8.0
1	11	14.7
2	24	32.0
3	22	29.3
4	11	14.7
5	1	1.3
Total	75	100.0

Source: Survey data

Table 5.4 shows the significance of the corporate governance report as the location of the sentences coded (of the 1,020 sentences coded, 63.7 per cent are in the corporate governance report. Next, the directors' report which is included in an annual report along with the statement of the chair, review of operations by the CEO and financial statements, is significant with 22.3 per cent of all the sentences coded. Statement of chair in annual reports coded does not have a significant per cent of the total coded sentences (13.2 per cent). The review of CEO and the biography or the details of the directors' page in the annual reports are insignificant as revealed by the number of sentences coded as a per cent of the total sentences coded (0.7 per cent and 0.1 per cent respectively). Therefore, the emphasis of the Berg (2004) to look across a document for the identification of the role of NEDs is not required.

Table 5.4 further points out that in the coded annual reports, which have a NED chair, there are more sentences when compared with the other two types of chairs that is simple chair and executive chair. Of the 1,020 sentences coded, 592 sentences (58.0 per cent of total sentences) are in the coded annual reports where there are NED chairs. In annual reports coded, when there are EC chairs, there are 205 sentences coded (20.1 per cent) and when there is simple chair, there are 223 sentences coded (21.9 per cent). Pettigrew and McNulty (1995) find that there are two types of board cultures namely maximalist and minimalist. Maximalist culture accommodates more discussions, listening, collaborative work and the minimalist boards are in the opposite side of these. Therefore, when there are NED chairs, there could be more opportunity for the NEDs as well as for

the executive directors to join in deliberations of the BOD. Thus, the number of sentences in the annual reports coded in which there are NED chairs could be a possibility.

Table 5.4

Origination of Sentences Coded

Type of Chair		Chair's report	CEO report	CG report	Directors' details	Directors' report	Total
Chair	Count	30.0	4.0	138	-	51.0	223
	% within chair	13.5	1.8	61.9	-	22.9	100
	% within location of	22.2	57.1	21.2	-	22.5	21.9
	% of total	2.9	0.4	13.5	-	5.0	21.9
EC chair	Count	32	-	125	-	48	205
	% within chair	15.6	-	61.0	-	23.4	100
	% within location of	23.7	-	19.2	-	21.1	20.1
	% of total	3.1	-	12.3	-	4.7	20.1
NED chair	Count	73	3	387	1	128	592
	% within chair	12.3	0.5	65.4	0.2	21.6	100
	% within location of	54.1	42.9	59.5	100	56.4	58.0
	% of total	7.2	0.3	37.9	0.1	12.5	58.0
Total	Count	135	7	650	1	227	1,020
	% within chair	13.2	0.7	63.7	0.1	22.3	100
	% within location of	100	100	100	100	100	100
	% of total	13.2	0.7	63.7	0.1	22.3	100

Source: Survey data

By looking at the above nature of distribution of the sentences as per the chair, we could make the proposition that when there are NED chairs, they have an influence on the dynamics of the BOD and when there are executive chairs, they are not so accommodative for the fellow directors to participate in BOD deliberations. This proposition is further supported by the spread of the number of sentences more in BODs where there are two to three NEDs (table 5.5) and when there are sub committees (tables 5.6 to 5.8) comprising the NEDs.

Table 5.5 shows that when the number of NEDs is two to three in the BOD, annual reports have the largest number of sentences coded (35.4 per cent and 30.5 per cent of all the coded sentences respectively). Categories, which take more than 2 per cent among the total number of sentences, are listed in table 5.5 with corresponding number of NEDs. While the argument of maximalist culture holds when there are more NEDs, Jensen (1993) and Walsh and Seward (1990) (Chapter 2) point out that when the number of directors are more than the adequate number for a corporation, there is a difficulty of seeing cohesiveness and the CEOs get the opportunity of seizing the cliques (among the BOD as well as the management who have informal links with the BOD), paralysing corporate governance or debates in the board. However, in regard to the table of 5.5, there is a question to ask whether the optimum average number of NEDs for an AIM company is 2 to 3 NEDs to make the BOD effective.

Table 5.5

Relationship Between Number of NEDs and the Number of Coded Sentences

Category	Number of NEDs						Total
	0	1	2	3	4	5	
Approvals	-	-	2.3	2.5	-	-	7.3
Inputs	-	-	2.5	-	-	-	5.5
Meetings	-	-	3.6	3.4	-	-	9.8
Organisation	-	2.2	3.1	3.7	-	-	11.0
Responsibilities	-	-	4.2	2.7	-	-	9.9
Revisions	-	-	3.1	3.2	-	-	9.2
Monitoring	-	-	2.4	-	-	-	5.8
Total	20	170	361	311	142	16	1,020
Percent of total	2.0	16.7	35.4	30.5	13.9	1.6	100

Source: Survey data

Most number of coded sentences appears when there are sub committees of the BODs where there are NED chairs (table 5.6 to 5.8). In corporations where there are audit committees, number of coded sentences are 87.6 per cent as against the corporations where there are no audit committees. The corresponding values for the corporations with the remuneration and nomination committees as against those corporations, which do not have such committees, are 84.2 per cent and 54.7 per cent respectively (table 5.7 and 5.8). In chapter 2 (section 2.8.4) we pointed out that there could be over compliance for the corporate governance regulations and the NEDs could be either pushed by themselves for corporate governance or the social forces could push them for corporate governance.

Table 5.6

Distribution of Coded Sentences and Audit Committee

Committee	**Type of Chair**			**Total**
Audit	**Chair**	**EC**	**NED**	
No audit committee	35	1	90	126
% of sentences	27.8	0.8	71.4	100
% within chair	15.7	0.5	15.2	12.4
% of total	3.4	0.1	8.8	12.4
Audit committee	188	204	502	894
% within committee	21.0	22.8	56.2	100
% within chair	84.3	99.5	84.8	87.6
Count	223	205	592	1,020
% within committee	21.9	20.1	58.0	100
% within chair	100	100	100	100
% of total	21.9	20.1	58.0	100

Source: Survey data

Table 5.7

Distribution of Coded Sentences and Remuneration Committee

Committee	**Type of Chair**			**Total**
Remuneration	**Chair**	**EC**	**NED**	
No remuneration	19	25	117	161
% of sentences	11.8	15.5	72.7	100
% within chair	8.5	12.2	19.8	15.8
% of total	1.9	2.5	11.5	15.8
Remuneration	204	180	475	859
% within committee	23.7	21.0	55.3	100
% within chair	91.5	87.8	80.2	84.2
Count	223	205	592	1,020
Within remuneration	21.9	20.1	58.0	100
% within chair	100	100	100	100
% of total	21.9	20.1	58.0	100

Source: Survey data

Table 5.8

Distribution of Coded Sentences and Nomination Committee

Committee	Type of Chair			Total
	Chair	EC	NED	
No nomination	84	79	294	457
% of sentences	18.4	17.3	64.3	100
% within chair	37.7	38.5	50.6	45.3
% of total	8.3	7.8	29.1	45.3
Nomination committee	139	126	287	552
% within committee	25.2	22.8	52.0	100
% within chair	62.3	61.5	49.4	54.7
Count	223	205	581	1,009
% within committee	22.1	20.3	57.6	100
% within chair	100	100	100	100
% of total	22.1	20.3	57.6	100

Source: Survey data

The above three tables point out (tables 5.6 to 5.8) the significance of the sub-committees of the BOD in corporate governance and also a possible tendency for more governance at the expense of the vital strategic role of the NEDs as argued by Taylor (2004). However, the degree of significance given for the sub-committees varies among the firms. This could be due to the firm specific factors such as the phase of growth of the company, appraisal of cost and benefit of sub-committees of the BOD, growth of the market and so on but the formation of such sub-committees could be a much relief for the FRC (2006) as it advocates more corporate governance.

5.3 Coded data – Rationalisation and Explanation

Stiles (2001:634) writes: 'Sentences which contained reference to the board's involvement in strategy were analysed and key verbs or qualifiers were highlighted to ascertain the mode of involvement'. As the above author argues, sentences could be considered as proxies for the tasks handled by the BOD and NEDs in their respective boards.

Table 5.9 shows the tasks of the NEDs within the BOD. First, pay our attention for the 'per cent within category'. For example, take the first column, 'advice' in table 5.9. There are 36 sentences which have the words denoting some form of advice, that is finance, managerial or general business advice (3.5 per cent of all the sentences coded). Within the 'advice category', 19 out of 36 sentences or 52.8 per cent originate in the annual reports where there are NED chairs. In the annual reports where there are executive chairs, coding found only 6 sentences or 16.7 per cent of the 'advice' category. In the annual reports coded where there is a simple chair, there are 11 sentences or 30.6 per cent within the 'advice' category. When we see the same for other categories, there could be seen that the per cent of share for many categories exceed 50 per cent in relation to the NED chair except objectives (41.7 per cent), proposals (35.3 per cent) and strategy (45.5 per cent). Taylor (2004) argues that the NEDs pay more attention for the corporate governance more than for the business strategy and objective setting in the context of the enhanced corporate governance needs. The above coded data supports this argument, in relation to the coded annual reports.

Table 5.9

Tasks of NEDs within the Unitary Board in the UK

Type of Chair	Sentences	Category																							
		Advice	Announcements	Approval	Authority	Beliefs	Communication	Considerations	Criteria	Decisions	Delegation	Evaluation	Expectations	Inputs	Leadership	Meetings	Objectives	Organisation	Proposals	Recommendations	Responsibilities	Revisions	Monitoring	Strategy	Scheduling	Total
Chair	N	11	0	18	3	10	3	7	2	1	2	3	8	8	1	22	5	21	6	10	24	23	17	10	8	223
	A	30.6	0	24.3	15	22.7	9.7	14.3	20	7.7	18.2	30	22.2	14.3	9.1	22	41.7	18.8	35.3	17.5	23.8	24.5	28.8	30.3	25	-
	B	4.9	0	8.1	1.3	4.5	1.3	3.1	.9	.4	.9	1.3	3.6	3.6	.4	9.9	2.2	9.4	2.7	4.5	10.8	10.3	7.6	4.5	3.6	21.9
EC Chair	N	6	1	13	1	8	9	9	1	4	1	2	7	9	2	26	2	23	5	10	22	17	12	8	7	205
	A	16.7	50	17.6	5	18.2	29	18.4	10	30.8	9.1	20	19.4	16.1	18.2	26	16.7	20.5	29.4	17.5	21.8	18.1	20.3	24.2	21.9	-
	B	2.9	.5	6.6	.5	3.9	4.5	4.4	.5	2.0	.5	1.0	3.4	4.4	1.0	13.1	1.0	11.6	2.5	4.9	10.7	8.3	5.9	3.9	3.5	20.1
NED Chair	N	19	1	43	16	26	19	33	7	8	8	5	21	39	8	52	5	68	6	37	55	54	30	15	17	592
	A	52.8	50	58.1	80	59.1	61.3	67.3	70	61.5	72.7	50	58.3	69.6	72.7	52	41.7	60.7	35.3	64.9	54.5	57.4	50.8	45.5	53.1	-
	B	3.2	.2	7.3	2.7	4.4	3.2	5.6	1.2	1.4	1.4	.8	3.5	6.6	1.4	8.8	.8	11.5	1	6.3	9.3	9.1	5.1	2.5	2.9	58.0
Total	N	36	2	74	20	44	31	49	10	13	11	10	36	56	11	100	12	112	17	57	101	94	59	33	32	1,020
% of total		3.5	.2	7.3	2	4.3	3.1	4.8	1.0	1.3	1.1	1.0	3.5	5.5	1.1	9.8	1.2	11.0	1.7	5.6	9.9	9.2	5.8	3.2	3.2	100

Source: Survey data

* N = Number of sentences, A = per cent of sentences within category, B = per cent of sentences within chair

A comparison with the EC chair and simple chair is worth and accordingly, it shows that the majority of the sentences coded belong to the annual reports where there are NED chairs. Why does a NED chaired company has more coded sentences could be answered by the thesis of maximalist culture explained earlier (Pettigrew and McNulty (1995). Two statistical tests which are used to see the relationship between the nominal categories (Cooper and Schindler, 2003), that is the association between the type of chair and the number of coded sentences show a significant relationship.

(1) Phi coefficient (Φ) = $\Phi = \sqrt{\chi^2/N}$ = .138 approximate significance is .914 and

(2) Cramer's V test = $V = \sqrt{\chi^2/N(k-1)}$ = .098 approximate significance is .914.

In order to understand the relative significance of each category according to the type of chair, we decide an arbitrary value to judge the most significant categories for a chair (as 5 per cent of coded sentences). Accordingly, table 5.9 shows that some categories are more significant for the chair. For example, the NED chair considers the following categories as significant relatively to others: board organisation (11.5 per cent), board responsibilities (9.3 per cent), board revisions (9.1 per cent), board meetings (8.8 per cent), board approvals (7.3 per cent), board inputs (6.6 per cent), board recommendations (6.3 per cent) and board considerations (5.6 per cent). When we apply the same rule for the executive chair, we could identify the following categories, i.e. board meetings (12.7 per cent), board organisation (11.2 per cent), board responsibilities (10.7 per cent), board revisions (8.3 per cent) and board approvals (6.3 per cent) rank high among the

categories. Within the simple chair, board responsibilities (10.8 per cent), board revisions (10.3 per cent), board meetings (9.9 per cent), board organisation (9.4 per cent), board approvals (8.1 per cent) and monitoring (7.6 per cent) takes higher values above 5 per cent. Across all the chairs, now we see that several categories are more important than others (organising the tasks of the board, board meetings, responsibilities, board revisions and board approvals). In the context of the emphasis for more vigilant corporate governance (Useem, 2003; FRC, 2006), the above tasks point out more dynamic board activities. However, this could be due to various pressures for more corporate governance by the regulatory authorities or for other reasons we discussed (section 2.8 in Chapter 2) such as the mimetic behaviour and isomorphic behaviour of the BOD and the NEDs to comply with the governance.

Sentences which convey some message whether there is evaluation of the performance of both the NEDs and the executive directors in the annual reports coded take only 1 per cent of sentences coded. Higgs (2003) found that the evaluation is one of the least considered board tasks. Useem (2003) evidently pointed out that criteria development for the managerial decisions and for the board tasks (see table 4.1 coding instrument) is one of the most needed but forgotten task in the BOD. Content analysis data also shows that there is less significance for the category of criteria (1.0 per cent). Rindova (1999), Forbes and Milliken (1999) and recently Haleblian and Rajagopalan (2006) point out the significance of cognitive tasks, namely, beliefs, considerations or assumptions and expectations. The coded number of sentences for these categories has a high value (4.3

per cent, 4.8 per cent and 3.5 per cent respectively), when compared to the category of evaluation and criteria (1 per cent for each of these).

5.4 Validity and Reliability of Content Analysis – Statistical Test

The aim of the Chi Square statistical test was to see whether the coded data is randomly distributed ensuring mutual exclusiveness and exhaustiveness of the categories. As explained in section 4.3.11 (chapter 4), categories which have 5 or less than 5 frequencies are removed to calculate the expectancy values (Cooper and Schindler, 2003). Accordingly, the total number of sentences remained 883 from the original number of 1,020 sentences (see table 5.9 and table 5.10). Table 5.10 shows the calculated expected values. The difference between the observed and the expected values (residual values) is a matter for further analysis if only there is a significant difference as explained in section 4.3.11. However, there is no much difference between the observed count and the expected count.

Table 5. 10

Calculated Expected Values for Chi Square Test

		Category													
		Advice	Approval	Beliefs	Considerations	Expectations	Inputs	Meetings	Organisation	Recommendations	Responsibilities	Revisions	Monitoring	Strategy	Scheduling matters	Total
Observed (O) and expected*																
Type of Chair																
Chair	O	11	18	10	7	8	8	22	21	10	24	23	17	10	8	197
	E	8	16.5	9.8	10.9	8	12.5	22.3	23	12.7	22.5	21	13.2	7.4	7.1	197
EC chair	O	6	13	8	9	7	9	26	68	10	22	17	12	8	7	177
	E	7.2	14.8	8.8	9.8	7.2	11.2	20	22.5	11.4	20.2	18.8	11.8	6.6	6.4	177
NED chair	O	19	43	26	33	21	39	52	112	37	55	54	30	15	17	509
	E	20.8	42.7	25.4	28.2	20.8	32.3	57.6	64.6	32.9	58.2	54.2	34	19	18.4	509
Total		36	74	44	49	36	56	100	112	57	101	94	59	33	32	883

Source: Survey data (calculations after removing the categories which have less than or five frequencies)

The Chi Square test statistic is computed as per the following formula using the observed and the expected values (see section 4.4.11 in chapter 4).

$$x^2 = \sum_i \sum_j \frac{(O_{ij} - E_{ij})^2}{E_{ij}}$$

Next, test the following null hypothesis with the alternative hypothesis or the research hypothesis to evaluate the Chi Square statistical test. If the Chi Square test statistic is greater than the table value with 95 percent of confidence for the relevant number of degree of freedom, null hypothesis is rejected, otherwise, accept the null hypothesis.

Ho: O = E means the observed value is equal to the expected value. Therefore, the generation of the categories are independent.

H1: O ≠ E means the observed values do not equal to the expected value. There could be significant differences or they are dependent.

The calculated Chi Square value is 16.85 with the degree of freedom of 26 (see appendix table 2). The table value for degree of freedom of 26 with the 0.05 confidence level is 38.88. As the calculated value is less than the table value, null hypothesis cannot be rejected. There is independence between the variables. On the other hand, it means that each category has its' own independent distribution with the protection of the properties in content analysis that is mutual exclusiveness and exhaustiveness. Further, this signifies that the content analysis data is randomly distributed.

5.5 Analysis of the Postal Questionnaire Data

As explained in section 4.4.3, 300 companies were randomly selected for the postal survey. Respondents sent 34 completed questionnaires (11.3 per cent) within three weeks. In order to increase the response rate, a reminder was sent with the questionnaire to the non-respondents in the third week. Within the set target date to complete the survey, further attempt was made through email and telephoning to a selected sample of non-respondents after the three week lapse for understanding the reasons for non-response. As a result, two companies sent back the questionnaire due to the lack of a CEO at present. One company sent an email indicating the non-availability of the CEO to fill the form.

Some CEOs have made useful contributions with their remarks in the completed questionnaires which are useful to develop the questionnaire further and also which made us to penetrate into the literature too. When compared to the response rate of the postal questionnaires of Stiles (2001) and Heuvel, Gils and Voordecken (2006), that is 13.4 per cent and 9.1 per cent respectively, the response rate of 11.3 per cent takes the mid value of the above two. However, this number of response is not adequate to see how the differences of CEOs, namely age, educational qualifications, tenure, nature of ownership of the firm and the relationship of the CEO to the firm vary in relation to CEO expectations on the contribution of NEDs, capabilities of NEDs, NED evaluation, and attitudes of CEOs.

In analysing the survey results, it is required to bear in mind, the significance of the type I error and type II error, especially when the response rate is low (Cooper and Schindler, 2003). Therefore, we believe that if we generalise the sample statistic values in our survey to estimate the population average of a certain phenomena in AIM companies, we do an unethical statistical practice. Therefore, we reserve this discussion only to analyse the frequencies and to get an insight as done by many authors who have used the frequencies to support their descriptions (Stiles, 2001; Heuvel, Gils and Voordecken, 2006).

Table 5.11 shows that the major contribution desired by the CEOs is for the development of the strategy (79.4 per cent). The AIM companies are floated with two aims that are acquisitions and expansion of the present business (AIM, 2007a). Therefore, it could be expected that the CEOs give more significance for the strategy. However, in the content analysis, strategy does not come as a significant category.

Table 5.11

Contribution Expected from the NEDs

Item	Description	Response	Percentage
a	To advise on the market opportunities in local and foreign markets	11	32.4
b	Supply of information needs not known to the company such as regulations governing markets	14	41.2
c	Advice the management on the development of business strategy	27	79.4
d	To evaluate the performance of the management, development of criteria for it	25	73.5
e	To liaise with the shareholders	5	14.7
f	Represent the company in social functions such as in local community, national events	14	41.2
g	Others	7	20.6

Source: Survey data

Table 5.11 shows that monitoring of the managers is also considered by the CEOs as an important role of the NEDs (73.5 per cent). In the context of the exposure of a PLC to the external world, mainly to the financial media and the analysts (Chapter 2), the significance given for the monitoring aspect of the NEDs could be understood. However, a quite different picture emerges when the CEOs are not keen to see the liaison with the shareholders as a significant aspect of the NEDs. Table 5.11 shows that there are only 5 responses or 14.7 per cent which have considered the role of liaison as significant. Our survey questionnaire has a plausible answer for this phenomenon. There were 32

responses who answered the question on the pattern of ownership and control structure of the firms (see questionnaire in appendix). Accordingly, 50 per cent of firms are controlled by two or more shareholders. The number of shareholders who has a substantial voting right (over 30 per cent) is 20.6 per cent. Only 50 per cent of the firms surveyed have a diffused ownership without a controlling shareholder. Authors point out that substantial concentration of ownership and the involvement of the owners themselves in the management of the firm itself is a corporate governance mechanism (La Porta, De-Silanes and Shleifer, 2002; Claessens and Fan, 2002; Cheng and Shiu, 2007).

Table 5.11 shows the varying degree of contribution expected by the CEOs from among a list of given factors. Accordingly, supply of information by the NEDs about the markets both local and foreign markets and regulatory environment is not seriously considered as a major contribution by the CEOs. However, this task is similar to what Stiles and Taylor (2001) identify as expansion of the boundary of the corporation. There could be two factors for the lesser significance for this aspect found in this survey. First, only 55.9 per cent (19 companies) are engaged in both local and foreign sales mostly with the countries in Europe. Second, the nature of the relationship of the CEO to the firm is also could be a significant factor for the lack of much dependence on the NEDs to get information about the markets as shown by the nature of the relationship of the CEO to the firm. In majority of the firms (47.1 per cent), CEOs themselves are the founders of the firms responded. There are only 44.1 per cent of professional managers or the hired managers by the firms. They do not have ownership stakes in the firms surveyed. Filatotchev (2006) pointed out

that when only the CEOs feel that they are not knowledgeable and inexperienced, they tend to depend on the NEDs.

Table 5.12 shows the ability of the NEDs to point out the managerial skills needed to see the future of the company as the most desired capability (73.5 per cent). The ability to win the respect of the executives (58.8 per cent) and the ability to evaluate the needs of the company such as technology and market opportunities (58.8 per cent) are desired by the CEOs. The ability to settle disputes among the managers and the shareholders are also considered as most important capabilities of the NEDs.

Table 5.12

Capabilities Expected from the NEDs

Item	Description	Response	Percentage
a	The ability to evaluate the future developments relating to company business environment such as new technology, market opportunities	20	58.8
b	The ability to point out how the company has to change its operations such as product developments	14	41.2
c	The ability to point out the necessary managerial skills to meet the future challenges	25	73.5
d	The ability to win the respect of the executives	20	58.8
e	The ability to introduce the necessary resources	7	20.6
f	The ability to settle disputes among the management and shareholders	20	58.8
g	Others	7	20.6

Source: Survey data

Table 5.13 shows that the CEOs evaluate the performance of the NEDs, mostly on the ability to develop the qualitative aspects of the management skills and the ability to establish social legitimacy with the stakeholders (67.6 and 64.7 per cent respectively). In chapter 2, research findings argued that the NEDs are a source for the creation of social legitimacy for the firm. Literature review (Chapter 2) identified that the need to establish social legitimacy drives the small and large PLCs to recruit NEDs. Table 5.13 shows that the least considered is the time spent in the company (26. 5 per cent) and the lack of a serious concern for the highlighting of structural weaknesses or the deviations from the plans (38. 2 per cent). There could be three factors responsible for this when we look at through the theoretical perspectives. As explained earlier, the ownership is not highly dispersed. Therefore, as the owner managers themselves work in the firms, there could be no consideration to get NEDs. Second, the reluctance of the CEOs to get feedback of their work from the NEDs and the fear of the NEDs to show any weaknesses in the management or the structures of the firm could be the other reasons, which are supported by the findings of Filatotchev (2006).

However, table 5.13 identifies that the CEOs wish the NEDs to bring vital sources of information both from within the firm and outside the firm. CEOs appreciate the suggestions of the NEDs to reduce the cost of purchasing, manufacturing cost and increase of sales (55.9 per cent). However, the CEOs are keen to strike a balance between their need to acquire knowledge from the NEDs and freedom in their own actions according to the overall analysis of the response on how they wish to evaluate the NEDs.

Table 5.13

Evaluation of NEDs

Item	Description	Response	Percentage
a	The inquisitiveness of the NEDs to search for necessary information for their work from within the company and outside the company environment	19	55.9
b	Strength of the advice in terms of their financial implications such as reduction of cost of manufacturing, purchasing, sales increase	19	55.9
c	Advice on the development of qualitative skills in management such as strategic planning, information technology, human resource management	23	67.6
d	Advice on the development of good relationship between the company and the shareholders and other stakeholders such as customers, employees and regulatory	22	64.7
e	Strength of pointing out any deviations of the desired work of managers such as the inefficiencies, lack of effort, violations of statutory rules	13	38.2
f	Time spent for the company such as the number of hours spent visiting the factories, meeting the employees of the company to get their views	9	26.5
g	Others	6	17.6

Source: Survey Data

The attitudes of the CEOs for three aspects of the NEDs were surveyed through the Likert scale questionnaire in table 5.14. They are: (1) attitudes on the nature of appointment of NEDs (a to h items), (2) motivation of NEDs to stay in the firm they serve (I to j items), and (3) additional appointments as NEDs (k to l items). Table 5.14 shows that the CEOs prefer the neutral NEDs as shown by the responses for the columns of strong agree (SA) and agree (A). If the CEOs get opportunities to work in other companies as NEDs, attitude of CEOs is that such appointments would bring knowledge and contacts for the company they work (A in item I and A in item k). CEOs also agree that there should be a limited number of such engagements as shown in the responses (SA in item L). However, the CEOs are uncertain whether the NED appointments for themselves could lead to non-monitoring of the fellow CEOs (Uncertain U in item j). The CEOs are indifferent for the question whether the NEDs are more towards monitoring due to their period of stay as NED to maintain their reputation as argued by Fame and Jensen (1983a). However, there is some tendency towards the time spent for the firm by the NEDs motivated by the need to protect their reputation according to the number of responses for the question on protection of reputation (item g).

Table 5.14

Attitudes of CEOs

	Attitude	Frequency percentages				
		SA	A	U	D	SD
a	If friends are appointed as NEDs by the CEO, they would be less likely to show unbiased evaluation of the performance of the CEO	26.5	41.2	14.7	11.8	5.9
b	If family members of large shareholders are appointed as NEDs, managers would be subject to excessive control	29.4	35.3	23.5	5.9	5.9
c	If the NEDs are appointed by the large shareholders, NEDs would tend to maximise their interests only	11.8	58.8	14.7	14.7	-
d	If NEDs do not have any relationships with the company such as business relationship or relatives, they would be fair for all shareholders	32.4	47.1	8.8	8.8	2.9
e	NEDs must be appointed looking into the specific needs of a company (for example, expansion of business in a foreign company with a NED from the host country	14.7	32.4	11.8	32.4	8.8
f	Level of effort of NEDs i.e. time spent for company business would be a decision depending on their share	2.9	14.7	23.5	35.3	20.6
g	Level of effort of NEDs will be a decision of the NEDs to maintain their reputation as good NEDs	2.9	47.1	20.6	29.4	-
h	In order to maintain individual reputation during the short period of their stay in a company relative to fulltime executives, NEDs would be towards the monitoring of	5.9	29.4	23.5	32.4	8.8
i	CEOs could get more insights in business development by serving as NEDs in other companies	23.5	58.8	2.9	14.7	-

j	If CEOs get NED positions in other companies, they would not monitor the CEO of the companies which they get NED positions	5.9	14.7	61.8	14.7	2.9
k	Managerial skills could be developed by a company by allowing its executives to get NED appointments in other companies	8.8	67.6	14.7	8.8	-
l	There must be a limited number of NED appointments held by a CEO	41.2	50	2.9	5.9	-

Source: Survey data

Table 5.14 could show us only a glimpse of some attitudes in the structured questionnaire. However, the data is adequate enough to make a reasonable judgement on several attitudes of the CEOs such as the nature of the NEDs they expect and their own style of contribution with the NEDs alongside of them. Therefore, the data in table 5.14 suggests us to look whether the CEOs are in a constant battle in their own minds in many fronts, namely their survival and ambitions to do what they wish to do when they work with the NEDs while there is a growing thrust for more corporate governance.

5.6 Conclusion

Content analysis shows multiple tasks of the NEDs. Some of these tasks such as the contribution on the strategy of the firm, advice and monitoring of the performance of the managers are explained in previous research (Chapter 2). Some of the tasks identified in the survey such as the cognitive tasks (beliefs, expectations, assumptions), are explained in the literature without adequate research in relation to the NEDs. Therefore, the content

analysis data has useful findings for the discussion in the next chapter in comparing and contrasting with previous research. In overall, the data collected shows the success of the research methodology and the ability of making a significant understanding of the role of NEDs.

Postal survey discloses the most significant contributions expected of the NEDs by the CEOs, what capabilities are expected of the NEDs and how the NEDs are evaluated by the CEOs. However, statistical analysis gives a limited ability to understand the role of NEDs comprehensively due to the inadequacy of the response. The response rate whether high or low for a postal survey, has to be seen with the understanding of the type I and type II errors discussed in Chapter 4. For example, if the sample is bias, it could give a bias estimate for the sample mean. These inherent weaknesses of sampling however the sampling is done and whatever the degree of confidence is set, required to be understood. Therefore, if the survey results are considered as capable of getting any insights into future research, the above statistical and sampling aspects have to be considered. However, such advice is not given in the papers reviewed to get methodological insights in the development of the research methodology for this survey (Chapter 4).

Chapter VI

Discussion

6.1 Introduction

Chapter 5 analysed the data obtained from the content analysis and postal survey. The content analysis found a large number of tasks of the NEDs apart from the corporate governance mechanisms in the AIM companies. Postal survey found what type of contributions and capabilities are expected from the NEDs by the CEOs and how the CEOs evaluate the performance of the NEDs. Postal survey also collected data on the attitudes of CEOs on various aspects of the appointment, motivation of NEDs for better performance and CEOs themselves getting NED appointments.

This chapter discusses the survey data. First, it discusses the major features of the findings, namely multiplicity and diversity of the tasks of the NEDs. This part is discussed with comparing and contrasting with the previous research findings on the tasks of the NEDs. Next, part is an attempt to see relationships of the tasks found in the survey in terms of the ability to link some tasks as independent and others as dependent tasks. Authors argue of the ability of finding relationships logically in concepts (Reynolds, 1971; Toulmin, Rieke and Janik, 1979; Harrigan, 1985; Walliman, 2005). Organisational, behavioural and managerial theories discussed in chapter 2 relating to various aspects in corporate governance are useful in the construction of the logical relationships of variables.

Accordingly, this part discusses several aspects of the role of the NEDs inferred from the survey namely, (1) the ability of the survey data to identify several tasks of NEDs, discussed only theoretically in literature, (2) the increased compliance by NEDs for corporate governance at the expense of the entrepreneurial and strategic aspects, (3) identification of relationship of tasks some as independent and others as dependent, and (4) the influence of the CEO on the role of NEDs.

When comparing the survey results with previous research findings, the title and the labels in the previous research is reporoduced as appeared (see Table 6.1). The reason for this is to show the existence of semantic differences among the labels used by authors (Deakins, O'Neil and Mileham, 2000; Stiles, 2001; Berry and Perren, 2001; Heuvel, Gils and Voordeckers, 2006). (In accounting, semantic differences are discussed and analysed (see Haried, 1973).

6.2 Multiplicity of Tasks and the Role of NEDs

Multiplicity and the diversity are the major two features found in relation to the tasks of the NEDs. Multiplicity is explained here as the existence of a large number of tasks. Content analysis finds 24 tasks of the NEDs (Table 5.9). Diversity in relation to the above tasks is here explained as the various ways of engagement in a particular task. For example, the task in relation to strategy has many variations of engagement such as planning, approval, revision and so on (Table 4.1). Table 5.9 shows further the varying degree of significance of the tasks. For instance, organising the activities of the board

takes a high value of 11 per cent of the sentences coded while setting of objectives take only 1.2 per cent of the sentences coded. The category of inputs (Table 5.9) identified as the task of studying various sources of information by the NEDs (Table 4.1 coding instrument), takes 5.5 per cent of coded sentences.

Therefore, the multiplicity of the tasks signifies that the role of the NEDs is a complex job. Within this complexity, it is possible to identify that the NEDs play a variety of roles or meet the expectations of several role senders such as the shareholders, CEO and regulatory authorities (Sarbin and Allen, 1968; Rogers and Molnar, 1976; Connell, 1979). Some of these tasks could be meeting the expectations of many role senders simultaneously. For example, the tasks of meetings (9.8 per cent), communication (3.1 per cent), beliefs (4.3 per cent) and expectations (3.5 per cent) could meet the needs of shareholders, CEO and 'regulatory authorities' (Jones and Pollit, 2003:2), such as Financial Services Authority (FSA) and Financial Reporting Council (FRC). Creation of beliefs and expectations among the above groups on the future of the firm is a cognitive task of the NEDs.

It could be identified that some categories (Table 5.9) are directly relevant to the monitoring of the managers by the NEDs. They are namely, advice (3.5 per cent), approval (7.3 per cent), evaluation (1.0 per cent), leadership (1.1 per cent), revisions (9.2 per cent), monitoring (5.8 per cent) and criteria (1.0 per cent). Fama and Jensen (1983a) explained the NEDs as professional referees. CEO expects a variety of contributions from the CEOs as shown in the postal survey too (Table 5.11).

Tasks identified

Type of Chair	Sentences	Category																						
		Advice	Announcements	Approval	Authority	Beliefs	Communication	Considerations	Criteria	Decisions	Delegation	Evaluation	Expectations	Inputs	Leadership	Meetings	Objectives	Organisation	Proposals	Recommendations	Responsibilities	Revisions	Monitoring	Strategy	Scheduling	Total
Chair	N	11	0	18	3	10	3	7	2	1	2	3	8	8	1	22	5	21	6	10	24	23	17	10	8	223
	A	30.6	0	24.3	15	22.7	9.7	14.3	20	7.7	18.2	30	22.2	14.3	9.1	22	41.7	18.8	35.3	17.5	23.8	24.5	28.8	30.3	25	-
	B	4.9	0	8.1	1.3	4.5	1.3	3.1	.9	.4	.9	1.3	3.6	3.6	.4	9.9	2.2	9.4	2.7	4.5	10.8	10.3	7.6	4.5	3.6	21.9
EC Chair	N	6	1	13	1	8	9	9	1	4	1	2	7	9	2	26	2	23	5	10	22	17	12	8	7	205
	A	16.7	50	17.6	5	18.2	29	18.4	10	30.8	9.1	20	19.4	16.1	18.2	26	16.7	20.5	29.4	17.5	21.8	18.1	20.3	24.2	21.9	-
	B	2.9	.5	6.6	.5	3.9	4.5	4.4	.5	2.0	.5	1.0	3.4	4.4	1.0	13.1	1.0	11.6	2.5	4.9	10.7	8.3	5.9	3.9	3.5	20.1
NED Chair	N	19	1	43	16	26	19	33	7	8	8	5	21	39	8	52	5	68	6	37	55	54	30	15	17	592
	A	52.8	50	58.1	80	59.1	61.3	67.3	70	61.5	72.7	50	58.3	69.6	72.7	52	41.7	60.7	35.3	64.9	54.5	57.4	50.8	45.5	53.1	-
	B	3.2	.2	7.3	2.7	4.4	3.2	5.6	1.2	1.4	1.4	.8	3.5	6.6	1.4	8.8	.8	11.5	1	6.3	9.3	9.1	5.1	2.5	2.9	58.0
Total	N	36	2	74	20	44	31	49	10	13	11	10	36	56	11	100	12	112	17	57	101	94	59	33	32	1,020
% of total		3.5	.2	7.3	2	4.3	3.1	4.8	1.0	1.3	1.1	1.0	3.5	5.5	1.1	9.8	1.2	11.0	1.7	5.6	9.9	9.2	5.8	3.2	3.2	100

Source: Survey Data

Note: * Reproduced the table in Chapter 5.

N = number of sentences, A = per cent of sentences within category, B = per cent of sentences within chair

There are some categories which could be identified as those which meet the aspirations of the shareholders (table 5.9). The tasks in relation to meet their expectations are identified as the following: announcements (0.2 per cent), communication (3.1 per cent), meetings (9.8 per cent) and recommendations (5.6 per cent). Regulatory authorities such as the FRC and BOE could expect a certain role from the NEDs (Jones and Pollitt, 2003). The category labelled responsibilities (9.9 per cent), scheduling (3.2 per cent), organisation (11 per cent) meetings (9.8 per cent) and delegation (1.1 per cent) could be considered as the result of activities directed towards meeting the expectations of the regulatory authorities too.

Thus, the survey finds that the NEDs meet the needs of different role senders simultaneously. Previous research has not made an attempt to understand the tasks of the NEDs through the perspectives of the role theory as illustrated above (Sarbin and Allen, 1968). However, the authors (Deakins, O'Neil and Mileham, 2000; Stiles, 2001; Berry and Perren, 2001; Heuvel, Gils and Voordeckers, 2006), have explained the tasks as roles (see the captions of the Table 6.1).

Role identified by four authors

'External director actions and roles' (Deakins, O'Neil and Mileham, 2000:120)			**'The role of board'** (Stiles, 2001:635)		**Contribution of NEDs** (Berry and Perren, 2001:165)		**Board role performance in small and medium sized family firms** (Heuvel, Gils and Voordeckers, 2006:479)		
Action/Role Listed in rank order	**VC set**	**NON VC**	**Interview response**	**No**	**Results from 180**	**No**	**Role**	**Control role**	**Service role**
Guidance and support	3.61	3.96	Involvement in strategy	32	Outside objectivity	73	Select new managers	0.983	-0.301
Discuss problems	3.73	3.61	Responsibility for monitoring health of the firm	20	Strategic planning process	50	Determine manager's responsibility	0.782	0.03
Discuss alternative solutions to problems	3.61	3.48	Hire appraise, and fire executives	7	Finance expertise	33	Determine salary/ Compensation for managers	0.708	0.07
Constructive criticism	3.52	3.52	Converse with shareholders/stakeholders	6	Operational expertise	31	Direct succession problems	0.652	0.012
Using the benefit of previous generalist experience	3.48	3.56	Ensure corporate renewal	5	Network of contacts	28	Maximise shareholder values	0.607	0.164
Emotional support	3.17	3.56	Development corporate vision	5	Structured board procedures	28	Evaluate/control management performance	0.495	0.369
Feedback	3.04	3.22	Responsibility for ethical framework	4	Helped with growth problems	16	Building organisational reputation	-0.204	0.871
Pointing out strengths and weaknesses	3.30	2.91	Ensure corporate survival	3	Brought marketing support	14	Networking and maintain relations	-0.141	0.822
Bringing discipline (to procedures)	2.48	3.13	Determine risk position	3	Provided ally on the board	13	Advising management	0.247	0.605
Clarifying responsibilities	2.74	2.13	Lead strategic change	2	Reduced board conflict	11	Formulate/ratify organisational strategy	0.214	0.559
Specialist assistance	2.74	2.74	Review social responsibilities	2	Gave confidence to financiers	11	Taking care of access to extra resources	0.237	0.495
Using the benefit of previous specialist experience	2.45	2.83	Act as ambassadors for the firm	2	Prestigious name on the board	9	-	-	-

Table 6.1 continued on next page

Ethical role	2.30	2.30	Understand current and forthcoming legislation	1	Helped with turnaround	7	-	-	-
Structuring tasks	2.26	1.96	Total	92	Competitor information	4	-	-	-
Relating concepts to practice	2.30	1.74	-	-	Customer information	7	-	-	-
Visionary ideas	2.09	1.83	-	-	Company flotation advice	1	-	-	-
Succession planning	1.61	1.91	-	-	-	-	-	-	-
Restructuring board composition	1.22	1.39	-	-	-	-	-	-	-

Source: Deakins, O'Neil and Mileham (2000); Stiles (2001); Berry and Perren (2001); Heuvel, Gils and Voordeckers (2006).

Lack of methodological insights for research into the role of BOD in the UK could be a possible reason for the failure of the authors to identify the tasks of NEDs through the perspectives of the role theory. Many authors argue of the lack of methodological insights in the theory on corporate governance (Stiles, 2001; Clarke, 1998; Hendry and Kiel, 2004; Pye and Pettigrew, 2005). There is still no general agreement for the development of labels for the roles of the NEDs as clearly evidenced with the study of Pye and Camm (2003) who introduce four roles of NEDs as Auditor, Super NED, Tame pensioner and Consultant. Pye and Pettigrew write: (2005:28) 'A lack of theoretical framework often undermines the impact of process studies, so we also advocate the need to develop stronger theoretical focus and explication about theorizing, encouraging clarity of epistemological assumptions under pinning the research process as well as perhaps also the use of well-established framing devices or concepts'. However, this factor could be seen as a potential arena for theorising the role of the NEDs.

Multiplicity of the tasks found in the survey creates a difficulty of putting the roles of the NEDs of AIM companies into four roles found in the large corporations, that is strategy, monitoring, service and boundary expansion or the introduction of the resources (Mintzberg, 1983; Stiles and Taylor, 2001: Johnson, Daily and Ellstrand, 1996) or even to the seven roles introduced by Mintzberg (1983): (1) selecting the CEO (removal including); (2) exercising direct control during periods of crisis; (3) reviewing managerial decisions and performance; (4) *coopting* external influencers; (5) establishing contacts (and raising funds) for the organisation; (6) enhancing the organisational reputation and (7) giving advice to the organisation. However, even in the large corporations, as Stiles

(2001) found (table 6.1), there is a difficulty of putting into the above roles as the author finds 13 roles.

Multiplicity of tasks arises due to the nature of the stage of development of the AIM companies. In large FTSE companies, the NEDs have a term of reference prepared as per the Combined Code (FRC, 2006). The AIM companies are not required to follow the above Code, but it emphasises the usefulness of the Code. Further, the main task of the NEDs in FTSE companies is monitoring the managers due to the large dispersion of the shareholders and the separation of ownership from management. In small and medium companies in the UK, NEDs involve in many tasks of the companies due to the growth stage of the companies, the need to build legitimacy in the process of getting equity capital, the need to develop the culture of corporate governance such as the board procedures and meetings with shareholders (Westhead, 1999; Deakins, O'Neil and Mileham, 2000; Berry and Perren, 2001; Long, Dulewcz and Gay, 2005; Heuvel, Gils and Voordeckers, 2006). Some of the tasks are discussed below with comparing and contrasting with the previous research findings.

6.2.1 Monitoring

Survey finds the significance of the monitoring function in both content analysis and the postal questionnaire survey (5.8 per cent in table 5.9 and 73.5 in table 5.11). Previous research also identifies the monitoring task as a most important task. Heuvel, Gils and Voordeckers (2006) explain among the control tasks, selection of new managers and

determining management's responsibility as the most significant task (table 6.1). Stiles (2001) in table 6.1 also finds the management aspect as important (responsibility for monitoring health of the company). However, Berry and Perren (2001) do not find this factor as significant. Deakins, O'Neill and Mileham (2000:120) do not use the word monitoring but find 'bringing disciplines' (table 6.1) and succession planning as vital roles. NED must be a devil's advocate in regard to the monitoring of managers according to one CEO whom we had correspondence, because the AIM companies are earmarked for expansion with the acquisition and subsequently issuing shares.

6.2.2 Advice

The survey finds that a key task of the NEDs is to advise on a range of matters, namely, market opportunities, staff development, financial management (3.5 per cent in table 5.9 and 79.4 per cent in table 5.11). Previous papers too identify the importance of the task of advice. Deakins, O'Neil and Mileham, (2000:120 in table 6.1) identify several tasks, that is guidance and support, discuss problems, discuss alternative solutions to problems, emotional support, feedback, pointing out strengths and weaknesses. These tasks are similar to the many dimensions in the coding instrument on the advice category in the content analysis (see table 4.1 coding instrument).

Stiles (2001) (table 6.1) does not have a clear identification of a label similar to the advice role. However, in the co-authored book with another author (Stiles and Taylor,

2001)[1], the role of advice is identified as most significant role. Berry and Perren (2001:165) (table 6.1) find several tasks falling into the advice category, that is 'helped with growth problems', 'helped with turnaround' and 'company flotation advice'. Heuvel, Gils and Voordeckers (2006) in table 6.1 divide the roles into two as control and service role and within the service role, authors identify the role of advice as significant.

6.2.3 Strategy

In the content analysis, strategy was identified as a significant role (3.2 per cent) and in the postal survey, CEOs expected strategy as a key role and they wished the NEDs to possess capabilities of scanning the environment, development of future business strategies and managerial capabilities and wished the intention to evaluate the NEDs on these aspects (Table 5.9 to 5.13). Many authors too find the strategy as a significant role of the NEDs. The most significant role according to Stiles (2001) is the involvement in strategy (table 6.1). Westhead (1999) finds that the strategy becomes the most significant reason for recruiting of NEDs to the small and medium companies. Berry and Perren (2001) and Heuvel, Gils and Voordeckers (2006) too identify the strategic role as significant. Deakins, O'Neill and Mileham (2000) (table 6.1) do not use the word strategy at all but use the phrase 'visionary ideas'. Vision is the first step in the process of strategy making. Coding instrument (table 4.1) included vision and mission into the category of strategy.

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[1] Research methodology of this book is reviewed in section 4.2 in Chapter 4.

6.2.4 Leadership

Leadership is not a strong task identified in the content analysis although the FRC (2006) stresses the significance of the leadership role. The value taken by the task of leadership among the total number of sentences is only 1.1 per cent (11 sentences in table 5.9). A further look at this table shows that only in the companies where there are NED chairs, majority of the sentences which could identify some form of leadership as identified in the coding instrument (Table 4.1) appear (8 out of 11 or 72.7 per cent in table 5.9). In previous research, authors have given various labels which could be dimensions of the category of leadership. Deakins, O'Neil and Mileham (2000:120) label this task as 'guidance and support' (table 6.1). The authors name another task as emotional support and there are more tasks similar to each other in the authors list (table 6.1). Stiles (2001:635) identify a role as 'lead strategic change'. Berry and Perren (2001:165) identify several roles similar to the leadership role and name them as 'helped with growth problems' and 'helped with turnaround' (table 6.1). When we discuss the role of advice, we have listed the above labels as advice. This shows the difficulty of putting some of the labels into a neat category due to many semantic difficulties and lack of rules of labelling as discussed in section 4.3.10.

6.2.5 Task of Organising the Activities in the Board

Content analysis found that the category called board organisation (see table 4.1 for dimensions), which include the development of the powers of the board by getting more

authority at the annual general meetings and getting new NEDs (table 5.9: 'board organisation' category takes 11 per cent). Deakins, O'Neil and Mileham (2000:120) identify several roles similar to above task, i.e. clarifying responsibilities, identify structuring tasks, restructuring board composition (table 6.1) and Berry and Perren (2001:165) identify reduced board conflict, structured board procedures and having appointed prestigious names on the board as tasks related to the strengthening of the board (table 6.1). Heuvel, Gils and Voordeckers (2006) find the strengthening of the BOD with the recruitment of the reputed directors as a major role of the board (table 6.1).

As explained in section 4.3.11 (Chapter 4), few excerpts from the annual reports coded for the content analysis are given to show the significance of the above tasks falling into the strengthening of the BOD: (1) 'During the year, we have restructured the BOD to reflect it's public company status' (Reneuron, Annual Report, 2006:3); (2) 'The directors intend to strengthen the Board through the appointment of at least one new NED' (LPA Group, Annual Report, 2006:4) and (3) 'The directors have established audit, nomination and remuneration committees with formally delegated rules and responsibilities. Each of the committees currently comprises the NEDs' (Celoxica Annual Report: 2006:15). These quotations prove the importance of the strengthening of the activities of the respective BODs.

6.2.6 Task of Studying Information for Decisions

Content analysis identified many sources of information required for the NEDs to be effective in the BOD meetings. CEOs, chair, financial media, financial analysts and regulatory agencies are the various sources of information to the NEDs. Postal survey also revealed the type of information desired, like for instance the supply of information needs not known to the company such as regulations governing markets abroad and competitor information (41.2 per cent table 5.11). Representation of the company by the NEDs in social functions such as in local community and national events is also identified as a source of facilitating the information collection (41.2 per cent in table 5.11). Stiles (2001) in table 6.1 has identified the understanding of current and forthcoming legislation as a task for the board. Berry and Perren (2001:165) (Table 6.1) identify similar roles as studying customer and competitor information as a role. According to the above nature of the information sources, there is a need to ask whether there is a lack of information or information overload (Jacoby, 1984). The next question is whether the NEDs use all these information for their work or whether they use the information for the companies where they work as executives. Many of these NEDs are executives in other companies (Chapter 2). On the other hand, information could be used to probe the assumptions of the managers with more confidence.

6.2.7 Task of Developing Cognitive Skills

Beliefs, expectations and considerations were identified in the content analysis as significant categories (table 5.9). Authors listed in table 6.1 do not identify the cognitive tasks. Cognitive tasks such as the beliefs, expectations and assumptions of the NEDs play a vital role in the development of positive beliefs for the corporation, development of morale of the management and winning the confidence of the shareholders (Pettrigrew, 1992; Rindova, 1999; Forbes and Milliken, 1999; Haleblian and Rajagopalan, 2006). Cognitive tasks are well supported in the literature as powerful motivators of individuals in the organisations (Steiner and Edmunds, 1979; Brief and Aldag, 1981; Gist, 1987). As explained in section 4.3.11 (Chapter 4), few extracts from the annual reports coded for the content analysis are taken to illustrate that the cognitive tasks influence the activities of the firm: (1) 'The Chairman and the Non-executive directors are responsible for the consideration and approval of the terms of service, remuneration, bonuses, share options and other benefits of the other directors. All decisions made are after giving due consideration to the size and nature of the business and the importance of retaining and motivating management' (Marvinwood, Annual Report, 2005:12); (2) 'The Board believes that the recruitment, motivation and retention of talented people is vital to the success of the Group and that these schemes can give us a real advantage in so doing compared to non-listed rivals' (City of London, Annual Report, 2006:3) and (3) 'Prospectus for the longer term are healthy and the directors are confident of further significant profit growth' (S and PLC, Annual Report, 2005:5).

6.2.8 Task of Communication

Communication aspect is a significant task of the NEDs as they are required to meet number of legal and social responsibilities discussed in chapter 2 (section 2.4). In the content analysis, we find that the NEDs inform the stakeholders how they have met these responsibilities through the tasks of communication (Table 5.9). Communication is a strong task especially among the NED chairs as found in table 5.9. This could be argued due to the expectations of the regulatory authorities such as the FSA and FRC as well as the shareholders both individual and institutional in the context of the increased significance given for corporate governance to enhance transparency and accountability. Yet, there is a need to understand this phenomenon through research. Stiles (2001) in table 6.1 finds the role of NEDs as ambassadors for the firm but does not identify what the tasks of the NEDs as ambassadors for the firm.

6.2.9 Task of Negotiation

The task of negotiation is a vital aspect of the NEDs as the disputes between the management and the shareholders and also with the employees have to be settled down. CEOs consider the capability of the NEDs to be skillful negotiators and also the ability of them to win the respect of the managers (Table 5.12). Both Cadbury (1992) and Combined Code (FRC, 2006) insist that there could be possible conflicts between the management and the shareholders. Therefore, there is a need of the NEDs to settle the

conflicts. O'Higgins (2002:25) finds that the negotiation is successful when the NEDs have interpersonal skills and the ability to win the respect of the managers.

6.3 Inferences from the Multiplicity of Tasks

The content analysis gives the opportunity to understand vital aspects of corporate governance emerging in the context of the enhanced emphasis for the role of NEDs (FRC, 2006). The significance of the appearance of the NED chair and the sub committees of the BOD (tables 5.2 and 5.3 in chapter 5) could be used to argue that there is increasing compliance for corporate governance by the corporate sector. Chapter 2 (section 2.8) pointed out that the non-regulatory codes on corporate governance makes a big pressure for the NEDs towards monitoring of managers and compliance rather than the strategy of the firm (see Taylor, 2004). When the chair is held by a NED and when the board has more NEDs, the board is open for discussions more, than the board dominated by the executive directors. Pettigrew and McNulty (1995) found that boards which give equal chance for the directors to discuss or make their points heard by the others, have more independent directors. They further find that such boards involve in corporate governance more than the boards, which have more executive directors.

Therefore, the survey could build a 'Rough hypothesis' (Berg, 2004:283) that the more NED directors lead to increased corporate governance. The statistical relationship of the association of the type of chair and the number of sentences was shown in section 5.3 (Chapter 5). Number of authors have found that the enhanced corporate governance

mechanisms such as the separation of the chair and the CEO, appointment of the audit committees and the NEDs could lead to more disclosures (Chen and Jaggi, 2000; Ho and Wong, 2001; Bushman, Piotroski and Smith, 2004; Barako, Hancock and Izan, 2006).

On the other hand, more disclosures and acceptance of the corporate governance principles could lead to poor attention for the entrepreneurial activities of the companies. Strategic contribution and entrepreneurship are pointed out as key aspects of the role of strategy in the Combined Code (FRC, 2006). Chambers (2005) argues that 'Many directors will concur with the sentiment that a greater proportion of their available time is now taken up with accountability, audit, risk management and control matters than was historically the case' (Chambers, 2005:28). Some themes in the content analysis, that is organisation, meetings, responsibilities and so on take a higher value among the total number of sentences examined than the sentences covered by the theme strategy. The social forces (section 2.8 in chapter 2) could push the NEDs towards compliance than the business needs of the directors, that is protection of reputation of NEDs (Fama and Jensen, 1983a; Cialdini and Goldstein, 2004).

6.4 Significance of the Cognitive Tasks of the NEDs

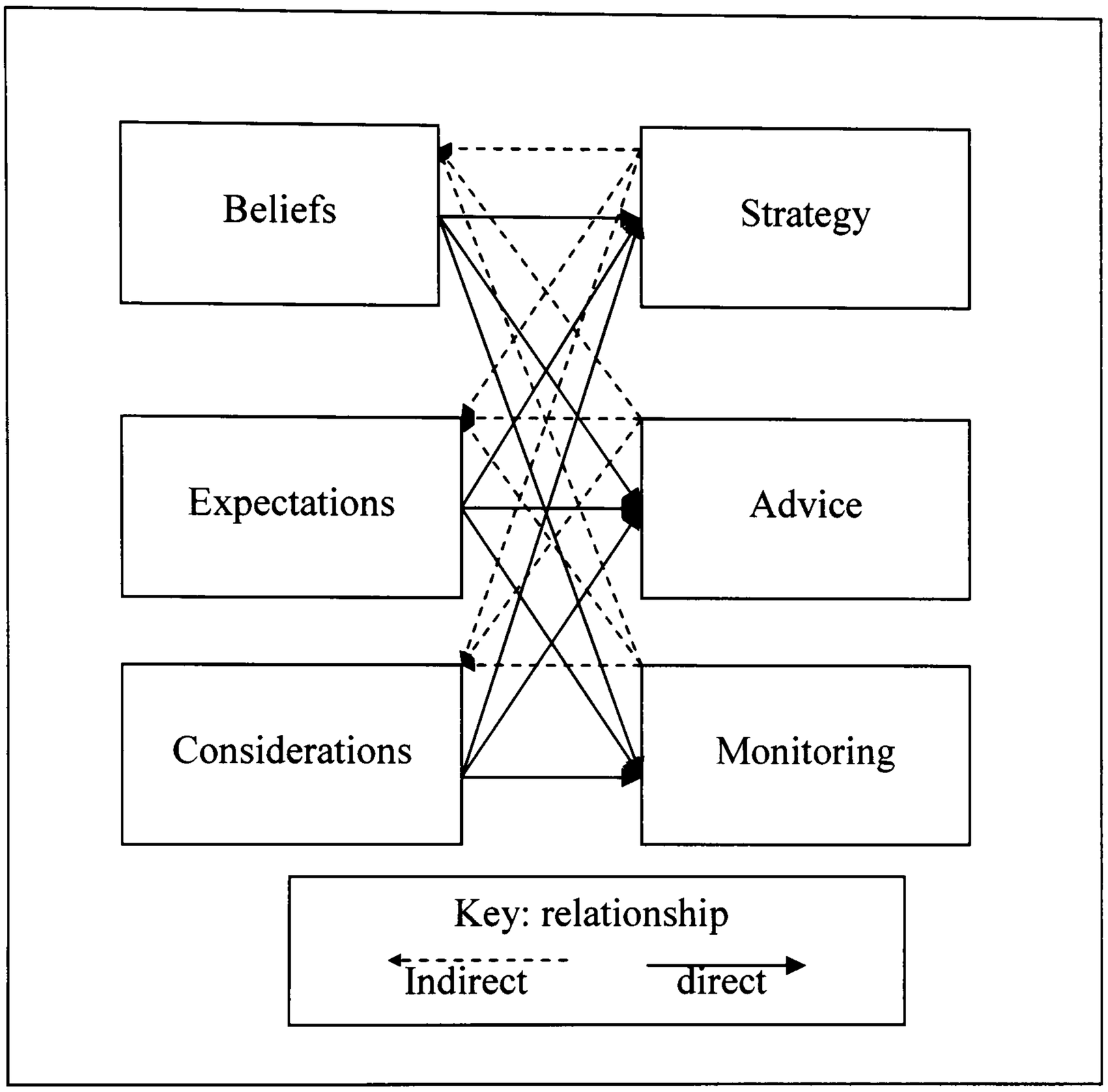
The tasks identified in the content analysis such as the development of criteria, monitoring, evaluation, setting objectives, delegation of responsibilities, scheduling of tasks and so on could be influenced directly or indirectly with the cognitive tasks

identified in table 5.9, namely, beliefs (4.3 per cent), considerations (4.8 per cent) and expectations (3.5 percent).

We could develop a rough hypothesis for future research (Berg, 2004) that there is a relationship between the cognitive aspects of the NEDs and the extent of involvement in strategy, advice, monitoring, development of criteria, evaluation, leadership, and so on. In figure 6.1, propositions are built to show the relationship of the cognitive tasks, with several other tasks. Cognitive tasks could influence the other tasks such as the development of criteria for management evaluation, liaison with the shareholders, setting objectives for the firm and so on to name a few. These relationships are shown in figure 6.1. The straight lines in figure 6.1 show the direct relationship and the dashed lines show how the outcome, that is the strategy, advice and monitoring themselves reinforce the cognitive tasks (see section 2.8 in chapter 2 for theory in organisational behaviour). Since the cognitive aspects are vital in the overall process of the role of the NEDs, further research is required to understand how the cognitive tasks are developed in the minds of the NEDs and what they are.

Figure 6.1

Testable Relationships in Content Analysis



Source: Survey data

As explained in the literature review (chapter 2), the management depends on the BOD on the overall direction of the firm (Jensen, 1993; Useem, 2003). We argue that the CEOs desire to see the cognitive tasks of the NEDs to match with their own as they are in charge of the management of the firm. Our postal survey attempted to understand the type of contribution and capabilities expected of the NEDs by the CEOs and on what criteria are the CEOs evaluate the NEDs (Table 5.11 to 5.13). Therefore, while the content

analysis has identified the cognitive tasks as a primary role of the NEDs, postal survey has identified that the desired roles of the NEDs have to be matched with the expectations of the CEOs.

The ability of the CEO to influence the role of NEDs is well documented (Ornstein, 1984; Westphal, 1998). Table 5.14 pointed out that the CEOs are keen to have independent NEDs in their BODs. According to the survey data (table 5.14), CEOs consider that the NED appointments made through friendship and family members of large shareholders would lead to biased evaluation of the performance of the CEO. This is in-fact has been pointed out by research (Mori, 2003; Higgs, 2003). Further the CEOs believe that the appointment of NEDs by large shareholders could lead to ill treatment of the minor shareholders (table 5.14).

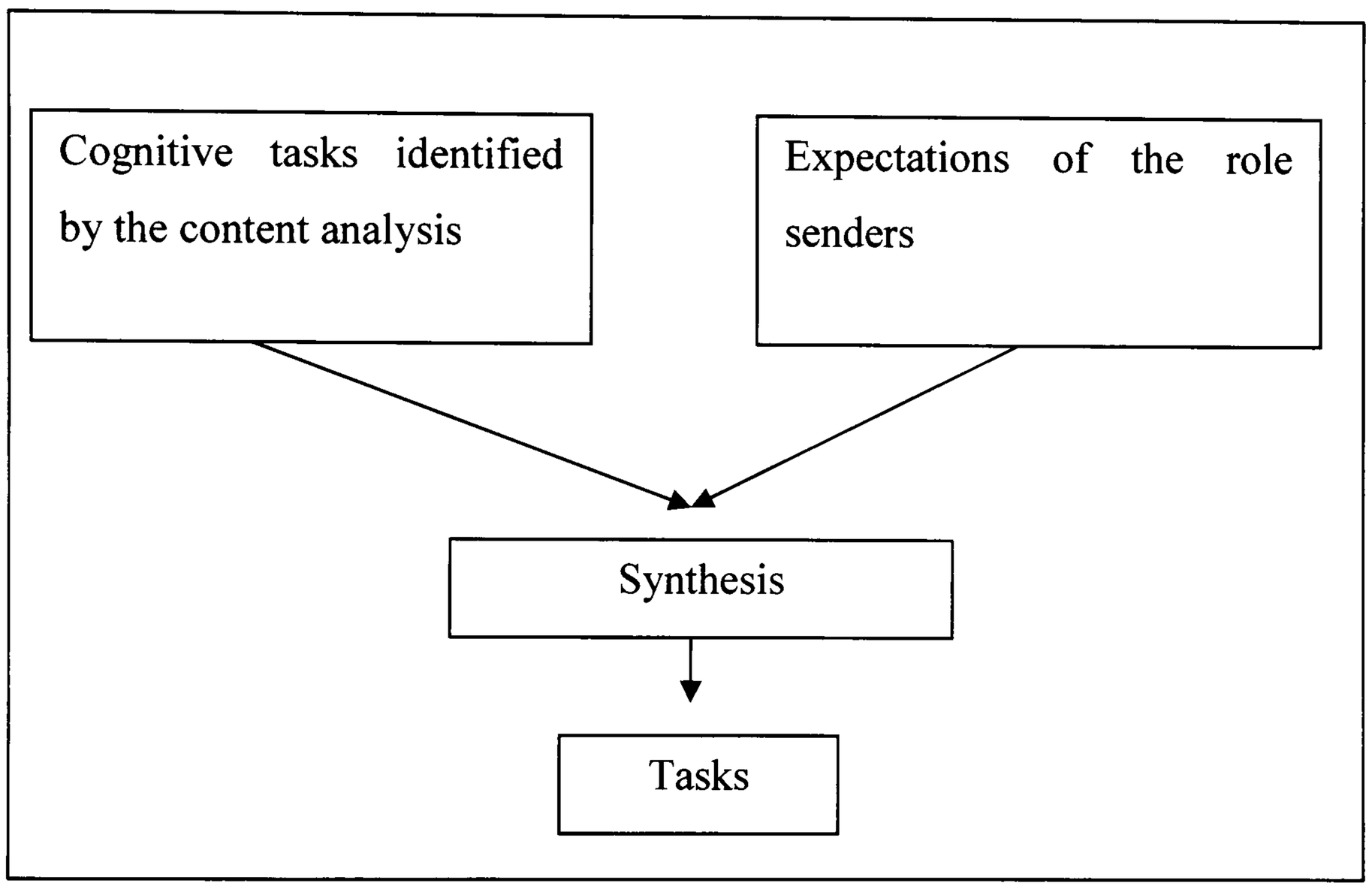
CEOs suggest that the appointment of the NEDs should be made on the specific needs of the companies (table 5.14). Therefore, we argue that the attitudes of the CEOs have a remarkable influence on the role of the NEDs and as the majority of the NEDs themselves are the CEOs or other higher management personnel in the corporate sector (Chapter 2), the CEOs could be influential in the role of the NEDs.

These logical relationships found in the content analysis and the postal questionnaire is drawn in figure 6.2. With the above discussion, figure 6.2 shows makes a proposition that that the role of NEDs is not so easily identifiable as the existing studies point out (O'Neill and Mileham, 2000; Stiles and Taylor, 2001; Stiles, 2001; Berry and Perren, 2001;

Heuvel, Gils and Voordeckers, 2006), but a result of the interplay of cognitive tasks and the expectations of the role senders. The CEO and the other various stakeholders expect various commitments and the role of NEDs is conditioned by many forces accordingly.

Figure 6.2

Synthesis of the Cognitive Tasks and the Influence of Expectations of the Role Senders



Note: This graph is a result of logical reasoning (Reynolds, 1971; Toulmin, Rieke and Janik, 1979) and mental mapping (Farrand, Hussain and Hennessy, 2002), supported with the survey results.

Source: Survey data

These findings are useful for NEDs to understand that the cognitive tasks are crucial in the mental mapping of how to identify the expected roles by the role senders (Sarbin and Allen, 1968), and the knowledge to be possessed by the NEDs. Authors argue that there is a constant need to evaluate the thinking process of the BOD as well as the thoughts of

the BOD in relation to the internal and external environment of the firm (Krogh, Roos and Slocum, 1994; Dixon and Dogan, 2003). We find in the content analysis that the NEDs engage in several cognitive tasks relevant to scan the internal and external environment.

6.5 Conclusion

The survey results discussed in this chapter points out the success of the content analysis and the postal survey to give an understanding of the role of the NEDs. The goal of research methodology (Chapter 4) was to understand the role of the NEDs. Accordingly, survey results generated a remarkable understanding of the tasks of the NEDs both visible and invisible such as the cognitive tasks.

This chapter points out that the existing knowledge in relation to the role of NEDs is blurred due to number of factors. First, there is no reliable system of labelling of the tasks identified in the existing literature. However, it was attributed due to the lack of a general theoretical framework to discuss the role of the NEDs. Second, the existing literature does not identify the role of NEDs through the perspectives of the role theory. Survey results point out the need to look at the influence of the CEO and the other stakeholders on the role of NEDs. Survey pointed out that the NEDs play a role to meet the needs of other stakeholders too such as the regulatory authorities.

The discussion of the data of content analysis and the postal survey evidently pointed out the usefulness of triangulation in research methods. Collection of data from different research methods means on the other hand use of several theoretical perspectives and philosophical underpinnings discussed in methodological text books (Crotty, 2003; Gray, 2004; Walliman, 2005). Therefore, this chapter makes a contribution to mixed methods research too apart from understanding the role of NEDs.

Chapter VII

Conclusion

7.1 Introduction

The study of corporate governance is still attracting the attention of both scholars and practitioners. Scholars are predominantly interested in the regulation and voluntary codes and how these are implemented in practice, whilst the practitioners, especially those involved with investment funds are more interested in practical aspects of corporate governance and how they can influence decision in the companies in which they have invested their and their investors' money. Advanced industrialised economies (notably the UK) has led the process and was the first country to endorse the voluntary code and promote the principle 'comply or explain'. Now, with the European Union (EU) it is the standard that companies do comply with the voluntary regulations and just a few opt for non-compliance and explanation of their position and behaviour.

Since the primer, Cadbury report published in 1992, a series of other acts in the UK have regulated corporate governance. Since the seminal Fama and Jensen's papers in the 1980s (Fama and Jensen, 1983a; Fama and Jensen, 1983b) it was just a question of time when the corporate governance as a practical consequence of separation between ownership and control would attract attention of all: legislators/regulators, investors, scholars, employees, etc. The stakeholder models and their growth in relative importance since the 1980s have certainly contributed to the public interest in the topical issues of corporate governance.

In this research, the researcher has studied the corporate governance framework and its application in practice in the UK, primarily with a view of using the UK experience to develop a model on the role of NEDs in corporate governance in Sri Lanka, which is an important Asian emerging market. As we have demonstrated Sri Lanka (formerly Ceylon) has increasingly started attracting investments from abroad, and the country as a whole following the introduction of market reforms has been on the fast growth track. Reports by international organisations are showing that the Sri Lankan economy is following the trends of recently liberalised Asian economies, recording the exceptionally good growth rates. The tsunami crisis has had adverse effects on the Sri Lankan economic performance, but despite this misfortune the country has been doing very well. More and more international investors are considering investing in Sri Lanka, and naturally, they are interested in the social dialogue issues at the macro-level, as well as corporate governance requirements, primarily, at the micro (company) level. In this study, the researcher has depicted the emerging picture of Sri Lankan corporate governance model, in relation to the very well developed (but permanently evolving) UK model. As the corporate governance is increasingly becoming a very complex area of study and practice, we have focused primarily on the role of NEDs in steering the company and being a sign of good, national corporate practices. To a large extent, the researcher believes that this study has proven that the role of NEDs is indispensable in modern corporate settings.

7.2 NEDs and Corporate Governance: UK vs. Sri Lanka

In order to complete this research, conducive environment to study the role of NEDs was gaining ground in the UK since 1990s. In the context of corporate collapses in

many countries in the recent decade including the UK, the government of the UK understood the significance of strengthening the role of NEDs (Higgs, 2003; FRC, 2006). The degree of significance given for the role of NEDs by the listed companies in the LSE is demonstrated through the appointment of sub-committees of the BOD headed by NEDs (audit, nomination and remuneration), appointments of a NED chair and establishing in many corporations a balanced board comprising the NEDs and the executive directors. NEDs are expected to bring outside objectivity, transparency and accountability to the corporate management. However, corporate governance problems emerge over and over again in many countries including the UK.

Despite the inability of the NEDs to prevent the recurring corporate governance problems such as the excessive remuneration for the CEO and other executive directors, frauds, corporate collapses due to the mismanagement of corporate funds and so on, the role of NEDs is identified as a significant factor in mitigating the corporate governance problems both in the UK and abroad including the emerging market economies such as Mainland China, Sri Lanka, Nigeria and so on. In the above context of strengthening the role of NEDs amidst the corporate governance problems emerging over and over again, re-examination of the role of the NEDs was identified as a researchable problem worthy of investigation due to the significance of corporate governance for an economy to establish strong capital markets.

In pursuing the study of NEDs in corporate governance, the researcher has endorsed research methodology, suitable to the research topic and the countries studied. Existing research is mainly based on objective research methods focusing on whether there is a relationship between the employment of the NEDs and the performance of

the firm. Further, the major emphasis in many papers was on whether the NEDs meet the interests of the shareholders, or they look at the wider picture. Among the subjective and interpretative research methods such as the interviews and observations of the role of the NEDs, the lack of a system of classification of the role of NEDs and labelling the roles also were identified. These methodological biases and weaknesses were addressed in developing the research methodology in this thesis. Accordingly, in order to ensure reliability and validity of the research instruments as well as the analysis of data and discussion of data, arguments of many authors were taken in relation to both the methodological aspects in general (Bacharach, 1989; Sutton and Staw, 1995; Walliman, 2005) and the arguments of many authors who had used the same research methods selected for this research. Third, arguments of some authors to use multiple methods of research into the role of NEDs was also paid attention in using two methods of data collection (Stiles and Taylor, 2001; Roberts, McNulty and Stiles, 2005).

Data (primary) has been mainly obtained through distributed postal questionnaire and the content analysis which has been widely used (see: Kassarjian, 1977; Weber, 1990; Hackson and Milne, 1996; Ahuvia, 2001; Jun and Cai, 2001; Beattie, McInnes and Fearnley, 2004 are a few to mention). Accordingly, development of the categories for the coding of annual reports, selection of annual reports, unit of analysis, method of analysis and discussion of findings and so on followed the arguments and the experience of many authors. The postal survey was also done to ensure reliability and validity with the selection of the CEO as the unit of analysis, random sampling of respondents and discussion of findings.

The theoretical framework to analyse the role of NEDs was based on the role theory (Sarbin and Allen, 1968; Rogers and Molnar, 1976). This theory argues that the tasks relevant to a role are decided by the person or persons who expect the role incumbent to play the expected role. Thus the NED is a person who is required to meet the expectations of several stakeholders such as the CEO, employees, customers and regulatory authorities such as the FRC and the FSA.

Analysis of data revealed two characteristics of the tasks of the NEDs, namely *multiplicity* and *diversity of the tasks*. Previous research has not found these characteristics in relation to the role of NEDs (Stiles and Taylor, 2001). Multiplicity of the tasks mean here as the large number of tasks. These tasks are namely, contribution to strategy, organising the activities in the BOD, delegation, communication with a diverse set of stakeholders, collection of information and studying them, leadership in company business operations, development of positive beliefs and expectations among the shareholders, advice to management and so on. Diversity in relation to the above tasks is here explained as the various ways of engagement in a particular task. For example, the task in relation to strategy has many variations of engagement such as planning, approval, revision and so on. Likewise, organising the activities in the BOD has many variations in practice by the NEDs namely, selection of suitable members to the BOD, scheduling of the activities of the BOD, decision on the formation of the sub-committees of the BOD, allocation of tasks among the members of the BOD and the sub-committees are a few to mention.

7.3 Contributions to Carry Forward the Debate on the Role of NEDs

Major contributions of this research to carry forward the debate on the role of NEDs are listed as follows. They are: (1) there are number of stakeholders namely shareholders, CEOs, regulatory authorities and so on who expect a certain role from the NEDs, (2) the influence of these stakeholders as well as the cognitive tasks of the NEDs themselves on their role, (3) large number of tasks (multiplicity) as well as diverse number of tasks or sub tasks within the main task (diversity), (4) difficulty of developing a general theory on the role of NEDs, (5) role of NEDs in AIM companies, (6) use of Chi Square analysis for the content analysis and (7) a review of literature review in the context of the implementation of the codes on corporate governance and a review of corporate governance experience in Sri Lanka. Previous chapters have discussed these items in details as such they are summarised below.

7.3.1 NEDs Meet Expectations of Several Stakeholders

This research clearly shows that NEDs could meet expectations of several stakeholders simultaneously, such as the CEOs, regulatory authorities, and shareholders. Previous research into the role of NEDs (See chapter 2) has not found such a phenomena. Therefore, it could be possible to imagine that the NEDs are a special kind of bees in the bee hive of BOD when compared with the specific roles of the executive directors. In the above context, NEDs take part not only on decision approval as found by Fama and Jensen (1983a) but also on decision taking too.

7.3.2 Influence of the Expectations of Stakeholders and Cognitive Tasks of the NEDs

According to the findings, the role of NEDs is conditioned by two forces namely their own cognitive tasks such as beliefs, assumptions and expectations, and by the expectations of the stakeholders. Cognitive tasks themselves could have a role to play in the decisions of the NEDs in relation to the strategy, monitoring of managers and expansion of the boundaries of the corporation. In previous research (Deakins, O'Neil and Mileham, 2000; Stiles, 2001; Stiles and Taylor, 2001; Berry and Perren, 2001; Heuvel, Gils and Voordeckers, 2006), not only the tasks are identified as roles but also they are identified as straight forward roles.

7.3.3 Multiplicity and Diversity of the Tasks

In this thesis, tasks are identified as dimensions of a role. This research finds a large number of tasks (24) (multiplicity) performed by NEDs. Within a particular task, various sub tasks were also identified (diversity) at the open coding stage. For example, strategy has many variations of contributions such as strategic advice, approval, monitoring, and implementation and so on.

7.3.4 Difficulty of Developing a General Theory on the Role of the NEDs

Our research reflects the difficulty of developing a general theory on the role of NEDs to meet the expectations of even the easily identifiable stakeholders such as the CEOs, shareholders, and regulatory authorities. The ambiguity of the identification of the

stakeholders (Stoney and Winstanley, 2001), infinite number of stakeholders (Sternberg, 1997), and difficulty of understanding the relative importance of the stakeholders especially in the context of the changing environment (Friedman and Miles, 2002) make the task of developing the general theory difficult.

Many authors have pointed out the difficulty of developing a general theoretical framework in corporate governance earlier but without making substantiate understanding in their papers as to why (Hung, 1998; Hendry and Kiel, 2004). Millstein (2008:3) points out that 'Corporations and their boards are a 'ZOO' of owners with different stripes, teeth, sensors, claws, vision, strength, will and attitudes'. Owners themselves vary from an individual investor to a large number of various institutional investors such as pension funds, mutual funds, private equity funds and so on. There are a number of regulatory authorities also who expect a certain role from the NEDs, mainly compliance for various standards such as accounting and auditing standards (FSA, 2006) and better corporate governance (FRC, 2006b).

7.3.5 Role of NEDs in AIM Companies

Role of NEDs in the AIM companies has not been studied in the context of the introduction of the non-regulatory Codes on Corporate Governance (FRC, 2006) though they are not relevant to the AIM companies. This research points out the implementation of the principles and the code provisions of the Combined Code on Corporate Governance (FRC, 2006) by a large number of AIM companies on a

voluntary basis. Thus this research shows the tendency of the AIM companies to implement good practices of corporate governance.

7.3.6 Use of Chi Square Statistical Analysis and Use of Manifest and Latent Variables in the Content Analysis

Papers which have used the content analysis technique (section 4.3 – chapter 4) have not used the Chi Square statistical test analysis to prove random distribution of data, and the two properties in content analysis that is mutual exclusiveness and exhaustiveness. Thus this thesis contributes for the content analysis technique. Previous research papers which use the content analysis use only the frequency analysis to discuss the data using only the manifest variables. But in this thesis, researcher uses the latent variables or the derivable variables from the manifest variables. Thus the analysis complies with the suggestion of many authors to use the latent variables too in the discussion of data (see Ahuvia, 2001; Cooper and Schindler, 2003).

7.3.7 Review of Literature on General Theoretical Framework and on Corporate Governance Experience in Sri Lanka

In the recent decade as well as in the context of the implementation of the non-regulatory Codes on Corporate Governance in the UK, there has not been a significant literature review on the role of the NEDs in particularly and on general theoretical framework on corporate governance. Corporate governance experience in emerging

countries is still to be researched according to many authors as pointed out in the thesis.

Therefore, this thesis contributes to understand the recent literature on the general theoretical framework on corporate governance as well as on corporate governance experience in Sri Lanka. This is especially useful for Sri Lanka which has introduced a code on corporate governance in which the appointment of NEDs is made mandatory.

7.4 Outcome of the Data Analysis

Analysis of the content analysis data shows that the NEDs perform 24 tasks (manifest variables). These are distinguishable to each other. Previous research has not identified some of these tasks namely; (1) organising the activities with the board, (2) study of information for decision taking, (3) development of criteria for the corporation such as for the recruitment of NEDs, CEOs and appointment of sub committees in the board, and (4) development of positive beliefs, expectations and assumptions (cognitive tasks) to enhance morale of the managers, shareholders and other stakeholders, and so on.

Latent variables were also identified through the manifest variables and the researcher argues the ability of identifying some of the tasks as independent variables and others as dependent variables. Accordingly, cognitive tasks were identified as independent variables and tasks such as strategy, monitoring and advice were identified as

dependent variables. Thus, among the outcome of the data analysis is the ability to develop number of theoretical propositions for future research (section 4.3.11).

In the discussion of the content analysis data, postal survey results were also used as done by many authors in previous research (see section 4.3.11 and 4.4.4 in chapter 4). Thus, triangulation of research methods benefited to shed some light on the content analysis data although a statistically significant response rate was not obtained for the postal survey. For example, it was possible to cross verify the significance of the role of the CEO as a key stakeholder in sending a message to the NEDs as to the expectations of the CEO. Many of the previous research findings too were supported by the postal survey such as the contribution of the NEDs to expand the resources of the firm and their contribution for the development of the strategy and so on. Thus this research benefitted by triangulation of research methods to a certain extent.

7.5 Limitations of the Study

In this study, researcher has largely focused on the role of NEDs in SMEs and therefore, the results of our research may be more of relevance to the AIM companies. Selection of a set of annual reports for the content analysis was done on a random basis from the annual reports received from the Annual Report Service in the UK. They too are unable to collect annual reports from all the AIM companies according to our inquiry. There are many studies which argue the accuracy of the declarations of annual reports (Atkinson and Coffey, 2004, Abeysekera, 2006). If the researcher does not assume that the declarations in the annual reports are correct, there will never be able to do a content analysis using the published documents. However, χ^2 test analysis

proved the randomness of the categories in the content analysis. Therefore, it is an assurance of the reliability of the content analysis.

Any research method has limitations to make a thorough understanding of a research problem due to various personal attributes (Walliman, 2005). Personal attributes decide the selection of a theoretical perspective and in turn the selection of the methodology and research methods. Lohrke, Bedeian and Palmer (2004:73) write: 'It is generally recognised that complex individuals process information differently from their cognitively less complex counterparts.' As a result, the development of coding instrument and designing of the postal questionnaire, data analysis and discussion and so on could be different among the researchers if they are put into the same task.

7.6 Future Research

This research can be extended in a few directions, and besides addressing the noted limitations, it also allows focus on completely new areas. First, the research can focus on the study of the distribution pattern of ownership, distribution of directorship, number of NEDs, nature of the appointment of NEDs, evaluation of the performance of the BOD and the NEDs, the role of shareholders in corporate governance, the nature of the institutional shareholders in Sri Lanka and their role and so on. It is also required to identify the expectations of the CEOs and the BODs, shareholders and the institutions such as the Security Exchange Commission and so on from the NEDs as the appointment of them are being proposed as mandatory in Sri Lanka.

7.7 Concluding Recommendations

A number of authors have studied extensively the issues of corporate governance and have offered a number of useful advices. To explain the advice for the management by the NEDs, authors use several terms such as help, guidance, support, feedback and so on which have a similar meaning (Deakins, O'Neil and Mileham, 2000; Stiles, 2001; Berry and Perren, 2001; Heuvel, Gils and Voordeckers, 2006). In order to develop a theory, it is required to develop a specific label for a particular task. Due to the lack of a clear term for the tasks of the BOD, annual reports use various terms for the seemingly similar task. In order to explain the dividends in companies, annual reports use several words, namely 'recommendation', 'proposal', and 'decision'. It is difficult to understand whether the recommendation is a final dividend payment or a proposal to the annual general meeting. Semantic problem had been pointed out by authors since the early 1970s (Smith and Smith, 1971; Haried, 1973; Morton, 1974). When there are semantic differences, understanding the meaning of a particular term could become difficult (Abeysekera, 2006; Atkinson and Coffey, 2004). Therefore, there is a need to look into this aspect.

7.8 Concluding Remarks

This thesis has certainly contributed to the better understanding of the role and position of NEDs in the context of modern, transforming organisation. Research has to be a continuous process in order to find the hither to unknown things and link them and bind them to develop a coherent theoretical framework. At present, this task is not seriously taken into the minds of the authors as evidently pointed out by Mizruchi

(2004), Piesse (2005) and Šević (2005). Mizruchi (2004) emphasises strongly that the sociologists have virtually forgotten to analyse the impact of the developments of the corporate sector in the recent decades other than appreciating the corporate sector which Berle and Means (1933) researched for their book. Piesse (2005) too appeals the researchers in social sciences to undertake research in corporate governance through new perspectives rather than attempting to see the relationship between the role of the NEDs and the performance of the firm. Šević (2005) points out that there is no continuity in research on corporate boards except when there is a major corporate collapse. In this context, this thesis is making a useful contribution in examining the role of NEDs in the context of the implementation of non-regulatory codes on corporate governance.

This research, which focused on the role of the NEDs, disagreed with the previous research which explain the role of NEDs as straight forward roles such as strategy, advice, monitoring and service but points out that tasks and the roles as two distinguishable things and the nature of inter-dependence of the tasks and the ability to identify the role of the NEDs through the expectations of many stakeholders but in order to develop a general theory on the role of the NEDs, the need to do more research on the role of NEDs through the use of multiple theoretical perspectives, methodologies and research methods across many research contexts.

The NEDs have been an important step forward for corporate governance policies and practices in the UK. Although, there were some reservations and limitations to the behaviour and expectation of the Boards, NEDs have arrived to stay. The duty is for the company to ensure appropriate training for NEDs and their role to be widely

accepted. NEDs have played a pivotal role in the studies of UK-based companies, whilst still in Sri Lanka many unacceptable practices may be regarded as normal, as they have not been outlawed. The UK experience may be more than satisfactory for an advanced economy, but additional problems will appear if the UK model is just to be replicated in Sri Lanka. Therefore, the environmental context (Johns, 2001), that is mainly the social, economic, political and legal environment along with the state of the development of the corporate sector has to be considered in the introduction and implementation of a role for the NEDs in Sri Lanka.

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Appendix 1 Postal questionnaire

Tel: 0208 331 8205

Fax: 0208 331 9924

Email: gw06@gre.ac.uk

05 May 2007

Chief Executive Officer,

……..,

……..

Dear Sir/Madam,

Re: Views of CEOs on the Role of the Non - Executive Directors

I am a PhD student under the supervision of Professor Željko Šević in the Business School of the University of Greenwich. My research is focused on understanding how the role of the Non - Executive Directors is seen by CEOs. This is particularly in the context of implementing the Combined Code of Corporate Governance 2003. I would be most grateful if you would spare a few moments to respond to the enclosed questionnaire. It has only 11 questions and should not take more than ten minutes to complete. The information would be used for research purposes only. I would greatly appreciate your prompt response. If you have any questions, please do not hesitate to contact me at gw06@gre.ac.uk or Professor Šević at Z. Sevic@gre.ac.uk.

With All the Best, I remain.

Yours faithfully,

Walter Gunetilleke

Enclosed: Questionnaire and the Business reply envelope

Questionnaire Survey

Please answer all the questions. Please mark (√) as many responses as you think appropriate.

Aims: To understand how CEOs view the following aspects in relation to the Non - Executive Directors (NEDs)

(1) Contribution expected from the appointment of NEDs

(2) Capabilities expected to possess by the NEDs

(3) Evaluation of the contribution of the NEDs

(4) Attitudes of CEOs on various issues related to appointment, performance and motivation of NEDs

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(1) Contribution expected from the appointment of NEDs

(a) To advice on the market opportunities in local and foreign markets

(b) Supply of information needs not known to the company such as regulations governing markets abroad, competitor information

(c) Advice the management on the development of business strategy such as acquisitions, strategic planning

(d) To evaluate the performance of the management/development of criteria for it

(e) To liaise with the shareholders

(f) Represent the company in social functions such as in local community, national events

(Please turn to next page)

(g) Others: (Please specify)

(i) .....

(ii) .....

(2) Capabilities expected to be demonstrated by the NEDs

(a) The ability to evaluate the future developments relating to company business environment such as new technology, market opportunities

(b) The ability to point out how the company has to change its operations such as product developments

(c) The ability to point out the necessary managerial skills to meet the future challenges

(d) The ability to win the respect of the executives in the company

(e) The ability to introduce the necessary resources for the company

(f) The ability to settle disputes among the management and shareholders

(g) Others: (Please specify)

(i) .....

(ii) .....

(3) Evaluation of the contribution of the NEDs

(a) The inquisitiveness of the NEDs to search for necessary information for their work from within the company and outside the company environment

(b) Strength of the advice in terms of their financial implications such as reduction of cost of manufacturing, purchasing, sales increase

(c) Advice on the development of qualitative skills in management such as strategic planning, information technology, human resource management

(Please turn to next page)

(d) Advice on the development of good relationship between the company and the shareholders and other stakeholders such as customers, employees and regulatory

agencies such as the Department of Trade and Industry

(e) Strength of pointing out any deviations of the desired work of managers such as the inefficiencies, lack of effort, violations of statutory rules

(f) Time spent for the company such as the number of hours spent visiting the factories, meeting the employees of the company to get their views

(g) Others: (Please specify)

(i) .....

(ii) .....

(Please turn to next page)

(4) Indicate the extent to which you agree or disagree with each of the following statements using the scale below in the cage opposite to each statement:

Strongly agree	Agree	Uncertain	Disagree	Strongly disagree
1	2	3	4	5

No	Statement	?
a	If friends are appointed as NEDs by the CEO, they would be less likely to show unbiased evaluation of the performance of the CEO	
b	If family members of large shareholders are appointed as NEDs, managers would be subject to excessive control	
c	If the NEDs are appointed by the large shareholders, NEDs would tend to maximise their interests only	
d	If NEDs do not have any relationships with the company such as business relationship or relatives, they would be fair for all shareholders	
e	NEDs must be appointed looking into the specific needs of a company (for example, expansion of business in a foreign company with a NED from the host country)	
f	Level of effort of NEDs i.e. time spent for company business would be a decision depending on their share ownership relative to other sources of income including compensation	
g	Level of effort of NEDs will be a decision of the NEDs to maintain their reputation as good NEDs	
h	In order to maintain individual reputation during the short period of their stay in a company relative to fulltime executives, NEDs would be towards the	

	monitoring of managers than the attention for strategic business development in the company	
i	CEOs could get more insights in business development by serving as NEDs in other companies	
j	If CEOs get NED positions in other companies, they would not monitor the CEO of the companies which they get NED positions	
k	Managerial skills could be developed by a company by allowing its executives to get NED appointments in other companies	
l	There must be a limited number of NED appointments held by a CEO	

General information on the firm and the respondent

(1) How do you describe the ownership and control structure of your firm

(a) The largest shareholder has a substantial voting right (Say over 30 %) and effectively control the firm ☐

(b) Two or more large shareholders collectively control the firm ☐

(c) Ownership is fairly diffuse with no controlling shareholder ☐

(d) Others (Please explain) (i) ..... (ii) .....

(2) The nature of the firm

(a) Stand-alone company ☐

(b) Subsidiary of a family-based business group ☐

(c) Subsidiary of a business group not controlled by families ☐

(d) Part of a family-based holding company

(e) Others (Please explain) (i) ..... (ii) .....

(3) What relation does the CEO has to the founder?

(a) Founder himself ☐

(b) Founder's family member ☐

(c) Professional manager ☐

(d) Others (Please explain) (i) ..... (ii) .....

(4) Does the company have foreign sales? **Yes** ☐ **No** ☐

(5) I belong to the age category

Less than 30		30 - 40		41 - 50		Over 50	

(6) I belong to the following category in my educational and professional training

Category	√
Diploma level	
Degree holder	
Degree plus professionally qualified	
Other (Please explain)	

(7) Could you please give us an appointment to further understand the issues related to the NEDs aimed and attempted to understand through this survey questionnaire

(Appreciate mentioning the date, time and the place if it is possible to allocate your valuable time)

Date: ..... Time ..... Place: .....

We appreciate your precious time spent and cooperation. Thank you.

Please send the completed questionnaire enclosed in the business reply envelope.

Appendix 2 Statistical table

Upper critical values of chi-square distribution with ν degrees of freedom

ν	Probability of exceeding the critical value				
	0.10	0.05	0.025	0.01	0.001
1	2.706	3.841	5.024	6.635	10.828
2	4.605	5.991	7.378	9.210	13.816
3	6.251	7.815	9.348	11.345	16.266
4	7.779	9.488	11.143	13.277	18.467
5	9.236	11.070	12.833	15.086	20.515
6	10.645	12.592	14.449	16.812	22.458
7	12.017	14.067	16.013	18.475	24.322
8	13.362	15.507	17.535	20.090	26.125
9	14.684	16.919	19.023	21.666	27.877
10	15.987	18.307	20.483	23.209	29.588
11	17.275	19.675	21.920	24.725	31.264
12	18.549	21.026	23.337	26.217	32.910
13	19.812	22.362	24.736	27.688	34.528
14	21.064	23.685	26.119	29.141	36.123
15	22.307	24.996	27.488	30.578	37.697
16	23.542	26.296	28.845	32.000	39.252
17	24.769	27.587	30.191	33.409	40.790
18	25.989	28.869	31.526	34.805	42.312
19	27.204	30.144	32.852	36.191	43.820
20	28.412	31.410	34.170	37.566	45.315
21	29.615	32.671	35.479	38.932	46.797
22	30.813	33.924	36.781	40.289	48.268
23	32.007	35.172	38.076	41.638	49.728
24	33.196	36.415	39.364	42.980	51.179
25	34.382	37.652	40.646	44.314	52.620
26	35.563	38.885	41.923	45.642	54.052
27	36.741	40.113	43.195	46.963	55.476
28	37.916	41.337	44.461	48.278	56.892
29	39.087	42.557	45.722	49.588	58.301
30	40.256	43.773	46.979	50.892	59.703

Source: http://www.itl.nist.gov/div898/handbook/eda/section3/eda3674.htm
Note: The web page has degree of freedom up to 100.