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Discussion paper by Dr. Gamini Wickramasinghe, Chairman of Securities and Exchange Commission of Sri Lanka for the 4<sup>th</sup> Session on **Corporate Governance: Methodology for Assessment of the Implementation of the OECD Principles and Discussion of Progress.**

**Recent developments in Corporate Governance for listed companies in Sri Lanka.**

The development of the capital market of any country depends largely on the performance of its listed companies and the confidence investors have in the listed companies. The effectiveness of the Board of Directors of those companies in carrying out their responsibilities is one of the main factors that determine the success or failure of those companies. Whilst it is agreed that Boards must be given the liberty to take business decisions without undue interference from regulatory authorities, it is equally important to ensure that Boards exercise that freedom within a framework of effective accountability and transparency. Sound Corporate Governance practices are recognized as the mechanism through which ethos of accountability and transparency in the conduct of the affairs of a listed company may be developed. It is believed that transparency and openness brought about by high standards of corporate governance would enhance investor confidence in the listed companies.

In Sri Lanka Corporate Governance initiatives commenced with the Institute of Chartered Accountants of Sri Lanka (ICASL) publishing a voluntary Code of Best Practice on matters relating to Financial aspects of Corporate Governance in 1997. Thereafter ICASL issued the Code of Best Practice on Audit Committees in 2002 and then jointly with the Securities and Exchange Commission of Sri Lanka the Code of Best Practice on Corporate Governance in 2003 in order to ensure that Sri Lankan standards relating to Corporate Governance are in line with the developments taking place in other parts of the world. Subsequently in 2004 the Securities and Exchange Commission of Sri Lanka issued a set of guidelines to listed companies relating to Audit and Audit Committees. These guidelines were not mandatory and were to be adopted on a voluntary basis. A survey conducted by SEC in 2005 relating to Audit Committees in listed companies has revealed that a substantial number of listed companies do not have audit committees. Also the said survey has revealed that although many companies have independent/ non executive directors in their audit committees a substantial number of companies have not appointed an independent/non executive director as the chairman of the audit committee.

Whilst the companies Act, No 17 of 1982 of Sri Lanka deals with regulation of companies it is inadequate in ensuring good management practices and hence is not very effective in ensuring good Corporate Governance. In the above context the need for a further initiative to ensure good Corporate Governance among listed companies was imperative and the Securities and Exchange Commission of Sri Lanka and Institute of Chartered Accountants of Sri Lanka in consultation with the Colombo Stock Exchange have spearheaded a joint initiative with a view to formulating standards on Corporate Governance. A salient feature of the draft rules on Corporate Governance is that compliance with such rules would be mandatory for listed companies as these standards are to be incorporated into the Listing Rules of the Colombo Stock Exchange. Once the draft rules on Corporate Governance are incorporated into the Listing Rules of the Colombo Stock Exchange non compliance would constitute a breach of the said rules. In the event of a breach of Listing Rules, as a first step, it is envisaged that there would be publication of the fact of breach together with the names of the companies which are in violation and the names of directors of such companies. The companies which continue to act in violation of the Listing Rules may be transferred to the default board and could be subject to a de-listing as a final option.

The draft standards were formulated by a select committee, which took account of Corporate Governance standards in several jurisdictions including the United Kingdom and New York with a view to formulate rules which take account of the realities of the Sri Lankan situation. The draft rules take a minimalistic approach, in this first instance, in an attempt to achieve openness, integrity and accountability in the affairs of listed companies, without being too onerous on the companies.

The draft standards focus on the following:

- The Board of Directors
- Audit Committee
- Remuneration Committee

### **The Board of Directors.**

In order for the board of directors to be effective it is essential that the board comprises of both executive and non-executive directors. Accordingly the draft rules mandate that the board of directors of a listed company should include at least two non-executive directors or one third of the total number of directors to be non executive directors whichever is higher. By specifying the minimum number of non-executive directors that should be present on the board the draft rules try to ensure that their views carry significant weight in the board's decisions.

The draft rules on Corporate Governance specify criteria for determining independence relating to a non executive director. Further in keeping with the disclosure based premise of these rules provision has been made for the non executive directors to make a self declaration as to their independence.

The draft rules mandates the board to make a determination annually as to the independence or non-independence of each non-executive director and set out in the annual report the names of directors determined to be 'independent'. The ultimate judgment regarding the independence of non-executive directors is left to the board and the board is mandated to make proper disclosures in the annual report relating to the basis of its determination which would be subject to scrutiny by the shareholders.

### **Audit Committee**

An annual audit plays a major role in achieving high standards of accountability and transparency. The separation of ownership from the management requires the directors to report to their shareholders on their stewardship through annual reports and financial statements. The audit provides an external and objective check on the way the financial statements are being prepared and presented. Audit committees play a major role in ensuring objectivity and effectiveness of the audit and also in terms of ensuring that the company has effective methods of internal controls and risk management in place.

As per the draft rules on Corporate Governance the audit committee should be comprised of a minimum of two independent non-executive directors in instances where a company has only two directors on its board or exclusively by non-executive directors a majority of whom shall be independent whichever shall be higher.

The chairman or one member of the committee should be a Member of a recognized professional accounting body. As per the draft rules on Corporate Governance the audit committee is responsible for promoting the integrity of the entity's financial reporting, making recommendations to the board relating appointment of external auditors and assessment of the independence and performance of the Company's external auditors.

### **Remuneration Committee**

It is well accepted that in the event executive directors are permitted to determine their own remuneration, a conflict of interest could arise. It is also accepted that remuneration of executive directors should be both fair and competitive, determination of which involves thorough study. A Remuneration Committee whose members do not have any personal interest in the out come is seen as the best suited to decide on it.

As per the draft rules the remuneration committee should comprise of a minimum of two independent non-executive directors in instances where a company has only two directors on its board or exclusively by non-executive directors a majority of whom shall be independent, whichever shall be higher.

### **Conclusion**

As the foregoing discussion reveals the draft rules on Corporate Governance in Sri Lanka too endeavors to embody principles of Corporate Governance akin to the principles that are enshrined in OECD principles of Corporate Governance and other accepted international standards. It is hoped that once implemented the draft rules on Corporate Governance would facilitate the enhancement of investor confidence and thereby strengthen the integrity and efficiency of the Capital Market of Sri Lanka.