

# Audit Committees Of Listed Companies In Sri Lanka

Securities and Exchange Commission of Sri Lanka

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September 2005



Securities and Exchange Commission of Sri Lanka

## FOREWARD

In the wake of major corporate scandals and failures, attention has come to be focused on promoting a culture of “Good Corporate Governance” within Listed Companies. Even though we do not have in Sri Lanka a binding code prescribing various requirements and best practices, it was assumed that most, if not all, Listed Companies have Audit Committees and other mechanisms and procedures. However, due to occasional reports that compliance with good Corporate Governance practices leaves much to be desired, the SEC decided a few months ago to conduct a survey focusing particularly on Audit Committees. Much to our surprise, we discovered that out of 132 Listed Companies that responded to the questionnaire, fifty companies (or 38%) did not even have an Audit Committee. The survey also revealed much variation in the composition, functions and operational modalities with regard to Audit Committees.

This report is published in the hope that Listed Companies will take action to establish Audit Committees, or if such Committees do exist, address any deficiencies or limitations. More and more members and investors examine the type of good corporate practices followed by companies when they make investment decisions, and it is no longer possible to be oblivious to the important role played by Audit Committees.

The Commission is grateful to one of its Commissioners, Mr. Udayasri Kariyawasam who also developed the questionnaire and assisted the Secretariat to administer it. The Chairman is also grateful to third year (2002/03 batch) students following the Accountancy Degree Programme at the University of Sri Jayawardenapura who analyzed the data to enable Mr. Kariyawasam to prepare the report. We are thankful to those Listed Companies that readily responded to our request to participate in this survey.

Dr. Dayanath Jayasuriya

**Chairman**

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## 1. Introduction

### 1.1. Audit committees in Sri Lanka

Audit committee is still not a mandatory requirement for Sri Lankan listed companies and it is not a listing rule of the Colombo Stock Exchange (CSE) either. The Institute of Chartered Accountants of Sri Lanka published its 'Code of Best Practice on Audit Committees' (ICASL Guide) in 2002 upon the recommendations of a Committee on Corporate Governance. The ICASL guide has addressed some of the key aspects of audit committees in terms of good governance. However, ICASL Guide needs revision, as it does not seem to be a comprehensive guide in terms of both depth and breath.

Subsequently the Securities and Exchange Commission (SEC) of Sri Lanka has issued a set of guidelines (Guidelines for Listed Companies – Audit and Audit Committees) (SEC Guide) to the listed companies in Sri Lanka in 2004. These guidelines do have a clause on audit committees (Section 6.A). However, these guidelines too were not mandatory for the listed companies. At the time of this survey these guidelines were in operational on a voluntary basis and the SEC does not have a mechanism to ensure compliance.

Our understanding about audit committees is that most of the listed companies has established audit committees on their own and operate without any regulation.

We were not able to find out any previous researches on this subject conducted by any institution, any professional body or a regulatory authority. This report may be a useful foundation for further research on this and related topics.

Some of the major points identified by this survey are the followings.

1. Some corporate managers do not understand the meaning of board committees, its importance and accountability of a board committee.
2. Some companies and officials do not have a clear idea about the objectives, powers and duties of audit committees.
3. The regulatory framework lacks definitive guidance on audit committees.

## 1.2. Listed companies in Sri Lanka

The official list of the Colombo Stock Exchange (CSE) contained 239 companies as at the date of this survey questionnaire (i.e. 20 July 2005). These companies have been categorized under 20 different sectors according to the core business activity. Number of companies existed under each sector at the date of survey is given in Table 1.1.

**Table 1.1**  
**Listed companies in Sri Lanka, sector analysis**

<b>Sector</b>	<b>No. of Companies</b>
1. Banks, Finance and Insurance	33
2. Beverages, Food and Tobacco	17
3. Construction and Engineering	04
4. Chemicals and Pharmaceutical	10
5. Diversified	09
6. Footwear and Textile	05
7. Health Care	06
8. Hotels and Travels	33
9. Investment Trust	07
10. Information Technology	01
11. Land and Property	21
12. Manufacturing	33
13. Motors	07
14. Oil and Palms	05
15. Plantations	18
16. Stores and Supplies	06
17. Services	07
18. Trading	12
19. Power and Energy	04
20. Telecommunications	01
<b>Total</b>	<b>239</b>

Source: Colombo Stock Exchange

The sector analysis of the companies, which responded to the questionnaire, is given in the Annex 1.

## 2. The Survey

### 2.1 Methodology

Even though these types of studies come under phenomenological paradigm we have selected the 'survey methodology', which comes under positivistic paradigm. This was not intended to be a sample-based survey since we transmitted the questionnaire to all 239 listed companies in Sri Lanka. However, we received only 132 replies (55 per cent of the total listed companies in Sri Lanka). Therefore, we were restricted to a sample size of 55 per cent. We used a questionnaire to collect the data, the responses to which we regard as the 'primary data'. In addition to the data collected through the questionnaire, we further collected some data from the company annual reports (secondary data) specially for the purpose of checking the audit committee disclosure in listed company annual reports. This survey does not fall within the meaning of 'descriptive survey'. On the other hand, it is not a 100 per cent 'analytical survey', as we did not mean to identify relationships between variables. The 'mixing methodology' would be the most suitable term that we can use to explain this approach.

We have categorized 132 companies under two different headings. We received 120 completed questionnaires as requested while 12 other companies did not return the questionnaire but instead they have written letters explaining various circumstances. In the circumstances, we categorized such companies as those that do not have audit committees.

### 2.2 Survey period

We transmitted the questionnaire to the listed companies in late July 2005 and requested them to reply on or before 10 August 2005. We received 106 replies on or before the cut-off date while 26 replies were received until 7 September 2005. Therefore the survey period extends from July to September 2005.

### **2.3 Objectives**

The following were the objectives of the survey.

1. Identify the composition and structure of the audit committees of the listed companies in Sri Lanka
2. Assess the level of compliance to the principles of good corporate governance
3. Provide insights and recommendations to enhance the effectiveness of audit committees in good governance

We have stated these objectives in the covering letter, which we transmitted along with the questionnaire.

### **2.4 The questionnaire**

The questionnaire comprised 23 questions with 14 open-ended questions and nine closed ended questions. All 23 questions were included in Part I of the questionnaire and Part II comprised administrative details. The proportion of open-ended questions to closed-ended questions is 1.5:1. The text of the questionnaire is reproduced in Annex 2.



### 3. Findings

#### 3.1 Board size

The minimum number of directors of listed companies in Sri Lanka is three (statutory minimum is two directors) and the maximum is 14. The average number of directors of a listed company was seven for the 120 listed companies, which have returned the completed questionnaires. Most number of companies (Mode) had seven directors on their boards. Sixty-five listed companies (54 per cent) had an even number of director while 55 listed companies (46 per cent) had an odd number of directors on their boards. Therefore it can be concluded that majority of listed companies do have boards of directors with an even number of directors.

#### 3.2 Chairman

Most number of companies did not have an independent/non-executive director as the chairman of the board of directors. Only 44 percent of listed companies or 52 listed companies had an independent/non-executive director as the chairman of the board of directors. Number of companies that did not have an independent/non-executive director as the chairman was substantial (56 per cent).

#### 3.3 Independent/non-executive directors

We found that 113 companies out of 120 or 95.8 per cent of the listed companies, which returned the completed questionnaires, had independent/non-executive directors on the board. Only five companies did not have any independent/non-executive director on the board. Two companies have not answered this question. A detailed analysis of independent/non-executive directors is given in Table 3.1.

**Table 3.1**  
**Analysis of independent/non-executive directors**

Description	No
Minimum number of independent/non-executive directors	1
Maximum number of independent/non-executive directors	10
Mode	3
Average	4
Companies did not have independent/non-executive directors	5

### 3.4 Chief executive officer

We found that the chief executive officer (CEO) was on the board of directors of majority of the listed companies. Of the 120 companies, which returned the completed questionnaire 88 listed companies (73 per cent) had the CEO on the board, 29 listed companies (24 per cent) did not have the CEO on the board and three companies have not responded to the relevant question.

### 3.5 Audit committees

Eighty two (62 per cent) listed companies among the 132 listed companies did have an audit committee. Of this 82 listed companies (85.4 percent) had independent/ non-executive directors in their audit committees. We stuck to the definition 'an audit committee is a sub set of the board of directors of the company' for the purpose of our survey. In other words we did not accept any other kind of definitions for audit committees. Most listed companies had a small number of directors in their audit committees.

Most of the audit committee chairmen were independent/non-executive directors while only 13 listed companies or 17 percent did not have an independent/non-executive director as the chairman of the audit committee. The relevant figures and percentages are given in Table 3.2.

**Table 3.2**  
**Analysis of composition of audit committees**

Description	No.	%
Total number of companies replied to the questionnaire	132	
Number of companies had audit committees	82	62.0
Number of companies with independent/non-executive directors in the audit committee	70	85.4
Number of companies with an independent/non-executive director as the chairman of the audit committee	62	75.6
Number of companies that the board chairman is also the chairman of the audit committee	7	8.5
Minimum number of directors in an audit committee	1	
Maximum number of directors in an audit committee	5	
Mode	3	
Average	3	

### 3.6 Independent/non-executive directors in audit committees

Most of the companies (mode) had three independent/non-executive directors in the audit committee. Details are given in Table 3.3.

**Table 3.3**  
**Independent/non-executive directors in audit committees**

Description	No
Minimum No. of Independent/non-executive directors in audit committees	1
Maximum No. of Independent/non-executive directors in audit committees	5
Mode	3
Average	3

### 3.7 Audit committee members other than board directors

The survey found that some audit committees include outsiders or non-directors as the members of their audit committees. The analysis is given in Table 3.4.

**Table 3.4**  
**Outsiders in the audit committees**

Description	No	%
Number of companies had audit committees	82	
Number of companies that included outsiders in their audit committees	29	35
Number of companies that included current employees in their audit committees	15	18

The survey further revealed that the CEO is also a member of the audit committee in some companies. There were 12 companies (15 per cent) that included the CEO as a member of the audit committee.

### 3.8 Qualifications of the audit committee chairmen

Only 33 (40 per cent) audit committee chairmen had a formal accounting related qualification. In other words majority of the listed companies do not have an audit committee chairman with a formal accounting related qualification. The questionnaire asked whether the audit committee chairmen have any of the following qualifications.

- Chartered Accountants ACA/(FCA)
- Chartered Management Accountants ACMA/(FCMA)
- Certified Chartered Accountants ACCA/(FCCA)
- Certified Practising/Public Accountants CPA/(FCPA)
- Commerce Graduates B. Com.
- Accounting Graduates B. Sc./B. BA./B. B.

The responses were as follows.

**Table 3.5**  
**Audit committee chairmen qualifications**

Name of Qualification	Number of Audit Committee Chairmen	%
ACA/(FCA)	24	73
ACMA/(FCMA)	5	15
ACCA/(FCCA)	0	-
CPA/(FCPA)	0	-
B. Com.	4	12
B. Sc./B. BA/B. B.	0	-
<b>Total</b>	<b>33</b>	<b>100</b>

### 3.9 Payments to audit committee members

The survey found that 42 companies (51 per cent) pay an additional allowance, other than the director fees, to the members of the audit committee for serving in the audit committee.

### 3.10 Audit committee charter

Only 43 companies (52 per cent) had a written audit committee charter out of the 82 companies that had audit committees. In other words the number of companies that do not have a written audit committee charter was 39 or 48 per cent. This was a significant number.

### 3.11 Audit committee meetings

It was revealed that 76.83 per cent companies hold at least three audit committee meetings in a year. Only one company had indicated it never hold an audit committee meeting. The analysis is given in the Table 3.6.

**Table 3.6**  
**Analysis of audit committee meetings**

<b>Number of Meetings</b>	<b>Number of Companies</b>	<b>%</b>
One	1	1
Two	8	10
Three	8	10
Four	44	54
Six	10	12
Twelve	1	1
On a need basis	8	10
Ad-hoc	1	1
Never	1	1
<b>Total</b>	<b>82</b>	<b>100</b>

Seventy eight listed companies prepare an agenda for the audit committee meetings. This is as high as 95 per cent and that indicates the fact that the audit committee meetings are formal. However, only 59 companies' (76 per cent) audit committee chairmen prepare the agenda for the audit committee meetings. Some other persons prepare agendas for the audit committee meetings of the rest of the companies. The analysis is given in the Table 3.7.

**Table 3.7**  
**Audit committee meeting agenda**

<b>Agenda prepared by</b>	<b>Number of Companies</b>	<b>%</b>
CEO	13	17
Audit committee chairman	59	76
Board chairman	6	8
<b>Total</b>	<b>78</b>	<b>100</b>

Twenty-three companies have indicated that they hold at least two meetings with their external auditors every year. Majority of the companies hold only one meeting with the external auditors. Further, 26 companies have indicated that they hold such meetings only on need basis. Surprisingly two companies have mentioned that their audit committee never meets with the external auditors. The details are given in the Table 3.8.

**Table 3.8**  
**Meetings with external auditors**

Number of Meetings	Number of Companies	%
One	31	38
Two	9	11
Three	2	2
Four	10	12
Six	2	2
Twelve	0	-
On a need basis	26	32
Ad-hoc	0	-
Never	2	2
<b>Total</b>	<b>82</b>	

The survey also revealed that six companies do not hold any meeting with the company's internal auditors. This represents seven per cent of the total 82 companies that do have audit committees. The relevant analysis is given in Table 3.9.

**Table 3.9**  
**Meetings with internal auditors**

Number of Meetings	Number of Companies	%
One	1	1
Two	4	5
Three	4	5
Four	22	27
Six	8	10
Twelve	0	-
On a need basis	34	41
Ad-hoc	3	4
Never	6	7
<b>Total</b>	<b>82</b>	

### **3.12 Specialists to the audit committee**

Audit committees of 69 companies had the powers to hire either accounting or legal specialists independently. That shows 84 per cent of the listed companies could hire such external specialists in order to assist the functions of the audit committee.

### **3.13 Whistle blower provision**

Only 56 companies had the whistle blower provision in their companies. This is 68 per cent of the total number of companies that had audit committees. In other words audit committees of 56 companies were able to act on anonymous information.

## 4. Sector Analysis and Disclosure

### Audit committees by sector

Data collected have been analyzed according to the 20 sectors in the Colombo Stock Exchange. The banking, finance and insurance sector had the most number of companies with audit committees (18 out of 20). All companies listed under Information Technology (IT) and Oil and Palms sectors have audit committees. The details are given in Table 4.1.

**Table 4.1**  
Sector analysis of audit committees

Sector	No. of Companies Listed	No. of Companies Replied	No. of Companies with Audit Committees	Audit Committee Chairmen with Accounting Qualifications	
					(%)
Banks, Finance and Insurance	33	20	18	8	44.4
Beverages, Food and Tobacco	17	11	8	4	50.0
Construction and Engineering	4	1	-	-	-
Chemicals and Pharmaceutical	10	5	2	-	-
Diversified	9	8	6	2	33.3
Footwear and Textile	5	2	1	1	100.0
Health Care	6	2	2	1	50.0
Hotels and Travels	33	14	6	2	33.3
Investment Trust	7	5	3	-	-
Information Technology	1	1	1	-	-
Land and Property	21	11	7	1	14.3
Manufacturing	33	12	8	6	75.0
Motors	7	5	4	3	75.0
Oil and Palms	5	5	5	-	-
Plantations	18	13	6	1	16.7
Stores and Supplies	6	4	1	1	100.0
Services	7	5	-	-	-
Trading	12	6	3	3	100.0
Power and Energy	4	1	-	-	-
Telecommunications	1	1	1	-	-
<b>Total</b>	<b>239</b>	<b>132</b>	<b>82</b>	<b>33</b>	



The above figures show that the majority of the audit committees of the listed companies of the following five sectors have chairmen with formal accounting qualifications.

- Footwear and Textiles
- Manufacturing
- Motors
- Stores & Supplies
- Trading

The summary is given in the Table 4.2.

**Table 4.2**  
**Sector analysis of audit committees with audit committee chairmen with formal accounting qualifications**

Sector	No. of Companies with Audit Committees	Audit Committee Chairmen with Accounting Qualifications	
			(%)
Footwear and Textile	1	1	100.0
Manufacturing	8	6	75.0
Motors	4	3	75.0
Stores and Supplies	1	1	100.0
Trading	3	3	100.0

## 5. Disclosure in Annual Reports of Existence of Audit Committees

Apart from analyzing the data collected through the questionnaire, we checked the company annual reports to find out the disclosure of audit committees. Out of 208 annual reports that were available only 78 companies have disclosed in their annual reports the availability of audit committees. Information disclosed was not consistent among the companies as there are no proper guidelines as to what information needs to be disclosed. However, even though some companies do not have their own audit committees they continue to maintain that they do have audit committees. This was the case in most of the group of companies where the parent company's audit committee overlooks the affairs of the subsidiaries (this is a finding of the survey). In our analysis in Part 3 we considered these companies as not having an audit committee. Table 5.1 gives the details as per annual reports together with a comparison with the details obtained from the questionnaire.

**Table 5.1**  
**Audit committees as per annual reports**

Sector	No. of Companies	Audit Committees as per Survey	Audit committees as per Annual reports
Banks, Finance and Insurance	33	18	23
Beverages, Food and Tobacco	17	8	3
Construction and Engineering	4	0	0
Chemicals and Pharmaceutical	10	2	2
Diversified	9	6	7
Footwear and Textile	5	1	1
Health Care	6	2	2
Hotels and Travels	33	6	7
Investment Trust	7	3	2
Information Technology	1	1	0
Land and Property	21	7	6
Manufacturing	33	8	9
Motors	7	4	6
Oil and Palms	5	5	5
Plantations	18	6	2
Stores and Supplies	6	1	0
Services	7	0	0
Trading	12	3	2
Power and Energy	4	0	0
Telecommunications	1	1	0
<b>Total</b>	<b>239</b>	<b>82</b>	<b>78</b>

## **6. Conclusions and Recommendations**

### **6.1 Conclusions and recommendations on the survey findings**

1. Some directors and officers have not understood the concept of 'audit committee' as a sub set of the board of directors. As a result some companies had appointed current employees and outsiders to the audit committees.
2. A substantial number of listed companies do not have audit committees. Audit committees must be made mandatory for listed companies.
3. Even though many companies have independent/non-executive directors in their audit committees still a substantial number of companies have not appointed an independent/non-executive director as the audit committee chairman.
4. Some companies have not separated the roles of the chairman and the CEO. Separation of these two roles is increasingly considered as a characteristic of good governance.
5. The survey noted that the CEO occupies a board position in some companies. Good governance principles implemented in some countries suggest that the CEO should not occupy a board position. This helps a clear distinction between the strategic and operational decision-making processes. Further, this also prevents the CEO being appointed to the audit committee.
6. Less than half of the audit committee chairmen of the listed companies had a formal accounting related qualification.
7. A majority of the companies having audit committees pay an additional allowance to the members of the audit committees for serving in the audit committee.
8. Listed companies hold varying number of meetings with the external and internal auditors. There must be a mandatory minimum number of audit committee meetings with such auditors.

9. A majority of the listed companies had a written audit committee charter. However, the number of companies that do not have a written audit committee charter was significant. A written audit committee charter is an important element for the proper functioning of audit committees in listed companies.
10. Only a few companies have provided for “whistle blowing”. Whistle blower provision must be a mandatory requirement in implementing audit committees in listed companies with procedures to entertain anonymous complaints.

## **6.2 General comments and recommendations**

1. Neither the ICASL Code nor the SEC Guide provides comprehensive guidance to listed companies on the role and functions of audit committees. Moreover, there were some differences and inconsistencies in these two documents.
2. It is necessary to prepare one guide on audit committees of listed companies in Sri Lanka and it should be implemented on a mandatory basis.
3. There must be clear definitions for important terms in line with internationally accepted terms i.e. Audit Committee, Independent Director, Non-executive Director etc.
4. There must be a mandatory requirement that all listed companies should disclose details of their audit committees in annual reports. The following are some of the important information that should be disclosed in the annual report.
  - The role of the audit committee
  - Audit committee charter
  - Audit committee chair and his/her qualifications
  - Audit committee composition
  - Names of audit committee members during the year
  - Audit committee meetings in particular how many with external auditors
  - Any significant findings/recommendations made by the audit committee
5. The SEC must have a mechanism to ensure that listed companies have in place functioning audit committees.

### Sector analysis of the companies that responded to the questionnaire

Sector	No. of Companies
1. Banks, Finance and Insurance	20
2. Beverages, Food and Tobacco	11
3. Construction and Engineering	1
4. Chemicals and Pharmaceutical	5
5. Diversified	8
6. Footwear and Textile	2
7. Health Care	2
8. Hotels and Travels	14
9. Investment Trust	5
10. Information Technology	1
11. Land and Property	11
12. Manufacturing	12
13. Motors	5
14. Oil and Palms	5
15. Plantations	13
16. Stores and Supplies	4
17. Services	5
18. Trading	6
19. Power and Energy	1
20. Telecommunications	1
<b>Total</b>	<b>132</b>

**SECURITIES AND EXCHANGE COMMISSION OF SRI LANKA**  
**Survey on Audit Committees of Listed Companies in Sri Lanka**

**Questionnaire**

**Instructions to complete**

- Please answer all questions in Parts One and Two.
- Information requested here is only for the company listed and not for its subsidiaries.
- Tick the appropriate box or insert the required number in the box where appropriate.
- Please return the completed questionnaire before 10 August 2005 in the envelope provided.

**PART ONE**

1. Number of board directors in your company
2. Number of independent or non-executive directors in your company
3. Is the chairman an independent or non-executive director?      yes       no
4. Is the CEO on the board of directors?      yes       no
5. Do you have an audit committee in your company?      yes       no
6. Number of directors in your audit committee
7. Does the audit committee have members other than the Board directors?      yes       no
8. Does the audit committee include any current employees of the company?      yes       no
9. Is the CEO a member of the audit committee?      yes       no
10. Number of independent or non-executive directors in your audit committee
11. Does the chairman of the board of directors chair the audit committee?      yes       no



22. Will the audit committee act on the basis of anonymous information? Yes  no

23. How many meetings does the audit committee have with the internal auditor during a financial year?

One  Two  Three  Four  Six  Ad-hoc

On a need basis  Never

## **PART TWO**

Name of the officer completed the questionnaire

Designation

Address

Contact telephone No(s).

Thank you

**Udayasri Kariyawasam – Commission Member – SEC**

20 July 2005



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