



Securities and Exchange Commission
of Sri Lanka

FINANCIAL REPORTING SURVEILLANCE PROGRAMME

31st December 2010



CORPORATE AFFAIRS DIVISION

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1.0 Introduction

The Securities and Exchange Commission of Sri Lanka was established to regulate the Securities Market in Sri Lanka. Its ultimate responsibility is to protect investors, and to maintain a fair, efficient and orderly market.

The commission regards financial reporting by the listed companies to be fundamentally imperative to the fairness, efficiency and transparency of the Sri Lanka's Capital Market.

The Commission's Financial Reporting Surveillance Programme

The Surveillance Programme was carried out with the aim of improving the quality of the financial reporting of the listed companies so that:

1. The Listed Companies' financial disclosures are clear, accurate and comprehensive.
2. Investors can have confidence in the credibility of financial information provided by the listed companies.
3. High quality financial reporting contributes to the integrity of the Sri Lanka's Capital Market.

The Financial Reporting Surveillance Programme involves review of the financial reporting practices of Listed Companies.

The purpose of the Commission's reviews is to form a view on

- a) The level of compliance with the Sri Lanka Accounting Standards (SLAS) as specified in the CSE Listing Rules.
- b) Whether any breaches of the SLAS identified in those financial statements are likely to have an impact on the true & fair view of the financial status and are likely to be materially misleading to users in the context of information disclosed as envisaged under the SEC ACT and therefore require enforcement action.
- c) The transparency, clarity, comprehensiveness of financial reporting disclosure requirements and the overall quality of financial reporting by Listed Companies.



2.0 Scope

A desktop review of each financial report is performed in the wider context of the annual report. For the purpose of evaluation of financial statements, issuers are selected based on the highest number of trades per year. Furthermore following factors are considered for timely feed back.

- 1 Number of complaints received
- 2 Unusual price fluctuations
- 3 Changes in company operations/ business activities
- 4 Restructuring or business acquisitions
- 5 Changes in company management(Corporate Governance)
- 6 Modified Audit Opinion (Emphasis of Matter, Qualified, Disclaimer and Adverse)
- 7 Changes in Auditors

The review covered 127 companies out of which 106 were concluded of the following sectors with Balance Sheet dates representing 31st March 2009, 31st December 2009 and 31st March 2010.

No	Sector Name	Number of Companies
1	Bank, Finance & Insurance	17
2	Beverage Food Tobacco	8
3	Chemicals& Pharmaceuticals	5
4	Construction & Engineering	1
5	Diversified Holdings	4
6	Footwear & Textiles	0
7	Healthcare	0
8	Hotels & Travels	21
9	Information Technology	0
10	Investment Trust	2
11	Land & Property	11
12	Manufacturing	10
13	Motors	2
14	Oil Palms	4
15	Plantations	9
16	Power & Energy	3
17	Services	2
18	Stores & supplies	2
19	Telecommunications	2
20	Trading	3
	Total	106



3.0 Identification of Issues

Out of the 127 annual reports reviewed, 106 were concluded as at the report date and 98 reports had matters that prompted the Commission to write to the respective companies. According to the magnitude of the issues identified but yet unresolved, either a letter of comment or a letter of caution was sent at the time of conclusion of the reviews.

A summary of the frequent violations of SLAS, Listing Rules, Company's Act and other significant matters are as follows;

3.1 Non Compliance with SLAS

It was observed that companies mostly violated the following Sri Lanka Accounting Standards.

(Refer Annexure 01)

SLAS 03 - PRESENTATION OF FINANCIAL STATEMENTS

- Para 76 (b): An entity shall disclose, either on the face of the balance sheet or in the notes, a description of the nature and purpose of each reserve within equity.

SLAS 18 – PROPERTY, PLANT & EQUIPMENT

- Para 43: Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately. ‘SLAS 18 – Property, Plant and Equipment’ was the accounting standard which was violated more than two times of that of the previous year (Refer Annex 03)
- Para 58: Land and buildings are separable assets and are accounted for separately, even when they are acquired together. With some exceptions, such as quarries and sites used for landfill, land has an unlimited useful life and therefore is not depreciated. Buildings have a limited useful life and therefore are depreciable assets. An increase in the value of the land on which a building stands does not affect the determination of the depreciable amount of the building.
- Para 59: If the cost of land includes the costs of site dismantlement, removal and restoration, that portion of the land asset is depreciated over the period of benefits obtained by incurring those costs. In some cases, the land itself may have a limited



useful life, in which case it is depreciated in a manner that reflects the benefits to be derived from it.

- Para 77: If items of property, plant and equipment are stated at revalued amounts, the following shall be disclosed by the entity:
 - (a) the effective date of the revaluation;
 - (b) whether an independent valuer was involved;
 - (c) the methods and significant assumptions applied in estimating the items' fair values;
 - (d) the extent to which the items' fair values were determined directly by reference to observable prices in an active market or recent market transactions on arm's length terms or were estimated using other valuation techniques;
 - (e) for each revalued class of property, plant and equipment, the carrying amount that would have been recognised had the assets been carried under the cost model; and
 - (f) the revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders.

SLAS 30 – RELATED PARTY DISCLOSURE

- Para 17- If there have been transactions between related parties, an entity shall disclose the nature of the related party relationship as well as information about the transaction and outstanding balances necessary for an understanding of the potential effect of the relationship on the financial statements. These disclosure requirements are in addition to the requirements in Para 16 to disclose key management personnel compensation. At a minimum, disclosures should include:
 - a) The amount of the transaction
 - b) The amount of outstanding balance and,
 - I. Their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and
 - II. Details of any guarantees given or received;

‘SLAS 30 – Related Party Disclosures’ was the accounting standard which was violated most. (Refer Annex 01)



- c) Provisions for doubtful debts related to the outstanding balances; and
- d) The expense recognized during the period in respect of bad or doubtful debts due from related parties.

➤ **Impact of Non Compliance**

- *SLAS 3* – Non disclosure of the nature and the purpose of the reserves facilitates the Companies to set aside their excess funds in terms of reserves instead of distributing to their shareholders or utilizing for general business operations with the immediate effect.

Recommendation: Therefore, the purpose and the nature of the reserves of the company should be disclosed to the investors to assess the reasonableness of such allocation.

- *SLAS 18* – Valuation of the Property, Plant and Equipment would represent a significant part of the assets in the Balance Sheet of a company.

Recommendation: Investors of the company are to be kept informed of the value of the asset base of the company in determining the value of their investment in the Capital Market.

This will enable the investors to assess the intrinsic value of the Company.

- *SLAS 30* – Transactions with the related parties represent the internal affairs of the companies within the group which at times apparently carry the interests of the management rather than the shareholders.

Recommendation: Company should inform the investors their business concentration within the group and the risks and rewards.

3.2 Non Compliance with Listing Rules

Among the 106 listed companies reviewed and concluded, 24 companies had not complied with listing rules. (Refer Annex 02)

Section 7.6 – Contents of Annual Report

- **Section 7.6 (iv):** The Public Holding percentage
- **Section 7.6 (viii):** Extents, locations,

‘Section 7.6 was the mostly violated section of the Listing Rules which stipulates the Contents of Annual Report’ (Refer Annex 02)



valuations and the number of buildings of the Entity's land holdings and investment properties

- **Section 7.6 (xi):** Dividend pay out
- **Section 7.6 (xii):** Significant changes in the Entity's or its subsidiaries' fixed assets and the market value of land, if the value differs substantially from the book value.

Section 7.10 - Corporate Governance

The Listing Rules pertaining to Corporate Governance has become mandatory effective from financial year ending 31.03.2009. Therefore, the compliance of these rules was reviewed stringently during the year.

- **Section 7.10.1 - Non – Executive Directors**

(a) The board of directors of a Listed Entity shall include at least,

- two non-executive directors; or
- such number of non-executive directors equivalent to one third of the total number of directors whichever is higher.

- **Section 7.10.2 - Independent Directors**

(a) - Where the constitution of the board of directors includes only two non-executive directors in terms of Rule 7.10.1.a above, both such non-executive directors shall be 'independent'. In all other instances two or 1/3 of non-executive directors appointed to the board of directors, whichever is higher shall be 'independent'

- **Section 7.10.3 – Disclosures Relating To Directors**

(a)- The board shall make a determination annually as to the independence or non-independence of each non-executive director based on such declaration and other information available to the board and shall set out in the annual report the names of directors determined to be 'independent'.

(b)- In the event a director does not qualify as 'independent' against any of the criteria set out below but if the board, taking account all the circumstances, is of the opinion that the director is nevertheless 'independent', the board shall specify the criteria not met and the basis for its determination in the annual report.



(c)- In addition to disclosures relating to the independence of a director set out above, the board shall publish in its annual report a brief resume of each director on its board which includes information on the nature of his/her expertise in relevant functional areas.

(d)- Upon appointment of a new director to its board, the Entity shall forthwith provide to the Exchange a brief resume of such director for dissemination to the public. Such resume shall include information on the matters itemized in paragraphs (a), (b) and (c) above.

- **Section 7.10.5 - Remuneration Committee**

A Listed Entity shall have a remuneration committee in conformity with the following:

- (a)- **Composition**

The remuneration committee shall comprise; of a minimum of two independent non-executive directors (in instances where an Entity has only two directors on its Board);
or

of non-executive directors a majority of whom shall be independent, whichever shall be higher. In a situation where both the parent company and the subsidiary are 'listed Entities', the remuneration committee of the parent company may be permitted to function as the remuneration committee of the subsidiary. However, if the parent company is not a Listed Entity, then the remuneration committee of the parent company is not permitted to act as the remuneration committee of the subsidiary. The subsidiary shall have a separate remuneration committee. One non-executive director shall be appointed as Chairman of the committee by the board of directors.

- **Section 7.10.6 - Audit Committee**

A Listed Entity shall have an audit committee in conformity with the following:

- (a) **Composition**

The audit committee shall comprise; of a minimum of two independent non-executive directors (in instances where a Entity has only two directors on its board);



or
of non-executive directors a majority of whom shall be independent, whichever shall be higher. In a situation where both the parent company and the subsidiary are 'listed Entities', the audit committee of the parent company may function as the audit committee of the subsidiary. However, if the parent company is not a Listed Entity, then the audit committee of the parent company is not permitted to act as the audit committee of the subsidiary. The subsidiary should have a separate audit committee. One non-executive director shall be appointed as Chairman of the committee by the board of directors. Unless otherwise determined by the audit committee, the Chief Executive Officer and the Chief Financial Officer of the Listed Entity shall attend audit committee meetings. The Chairman or one member of the committee should be a Member of a recognized professional accounting body.

Please refer Section 7.10 – Corporate Governance for comprehensive guidelines.

➤ ***Impact of Non Compliance***

- *Section 7.6* – This section supports the assessment of the general environment of the company at a glance.

Recommendation: Investors should have the right to access the basic information of the companies where they want to invest to assess the risks involved in their prospective investments.

- *Section 7.10* – The entire process of achieving both the short term and long term the goals and objectives of the Company are sphere headed by the Board of Directors. This involves building sustainable value for the shareholders and all its other stakeholders which is really what good Corporate Governance means.

Recommendation: “Good Corporate Governance is essential to the effective operation of a free market, which enables wealth creation and freedom from poverty”. (Financial Reporting Council of the UK)



4.0 Review and Enforcement

The Commission's approach is to write to an issuer on a matter identified in a review where the nature of the matter prompts it to be of regulatory importance or further clarification of information is required.

The Commission writes to issuers requesting additional information and in some cases asks issuers to revise or enhance disclosures in future financial statements. According to the seriousness of matters identified either a Letter of Comment or a Letter of Caution was sent.

- A Letter of Comment issued by SEC suggests necessary changes to the financial statements of companies.
- A Letter of Caution is a letter sent to listed companies who have contravened laws & regulations which have a bearing on investor protection. Via such Letters of Caution we bring to the notice of the listed companies concerned the exact provisions which have been violated and caution such parties against such violations.

4.1 Overall Comment

We found violations and non compliances with SLAS, Listing Rules and Companies Act. It was observed that SLAS 30, SLAS 18 and section 7.6 and 7.10 of the Listing Rules were mostly violated.

Oil Palms Sector carries the highest percentage of violations sector wise (Refer Annexure 04)

According to the analysis up to 31st December 2010, we have sent 39 letters of Comment and 5 Letters of Caution, out of 106 company reviews which were concluded.

Three cases are under legal scrutiny, investigation and the regulatory committee to review the necessity of any enforcement action.

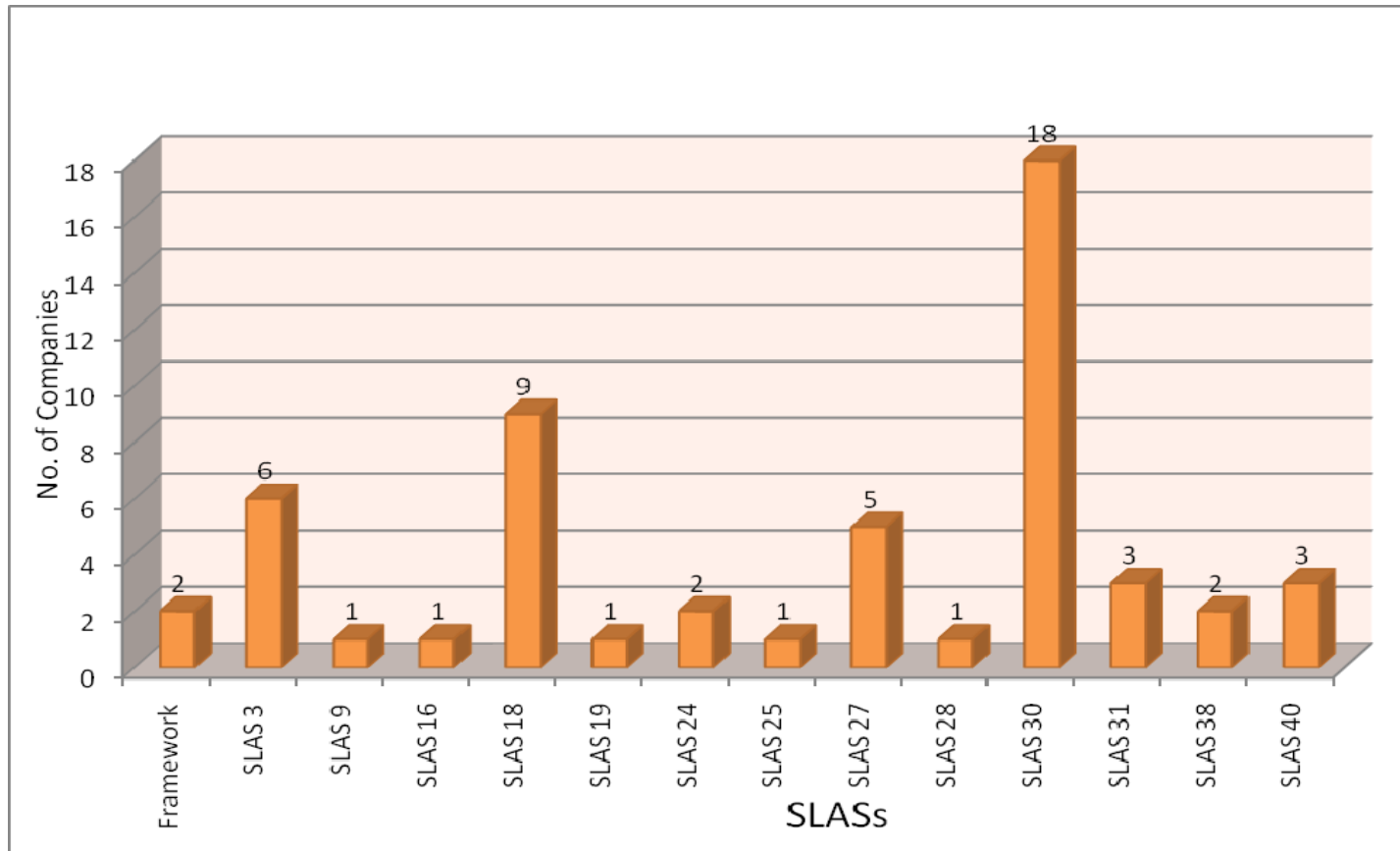
We have referred four matters to SLAASMB for further technical opinions.

The Commission encourages issuers to ensure that all of their disclosures are sufficiently clear to explain matters included in their financial reports and should review their compliance with statutory requirements as a critical step in the preparation of an annual report.

The Commission will continue to review the listed companies' financial reporting as part of the Financial Reporting Surveillance Program and instigate steps appropriate to encourage adherence to Financial Reporting requirements under SLAS, Listing Rules and Companies Act.

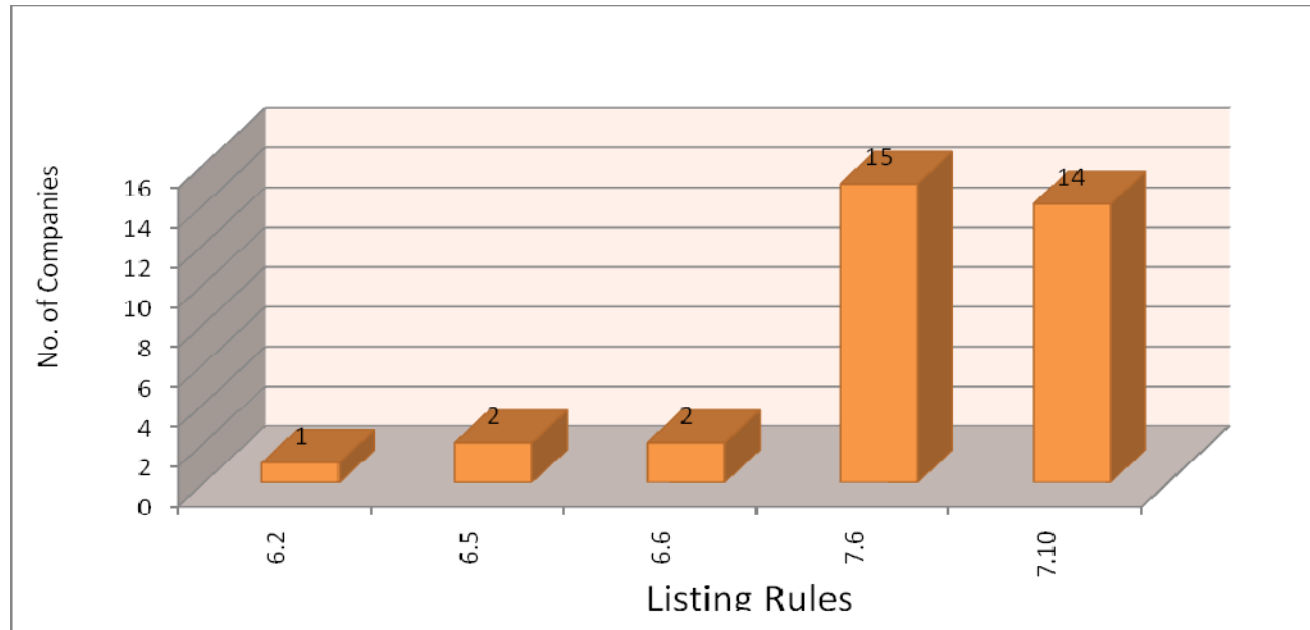


ANNEX 1 Non Compliance with SLASs

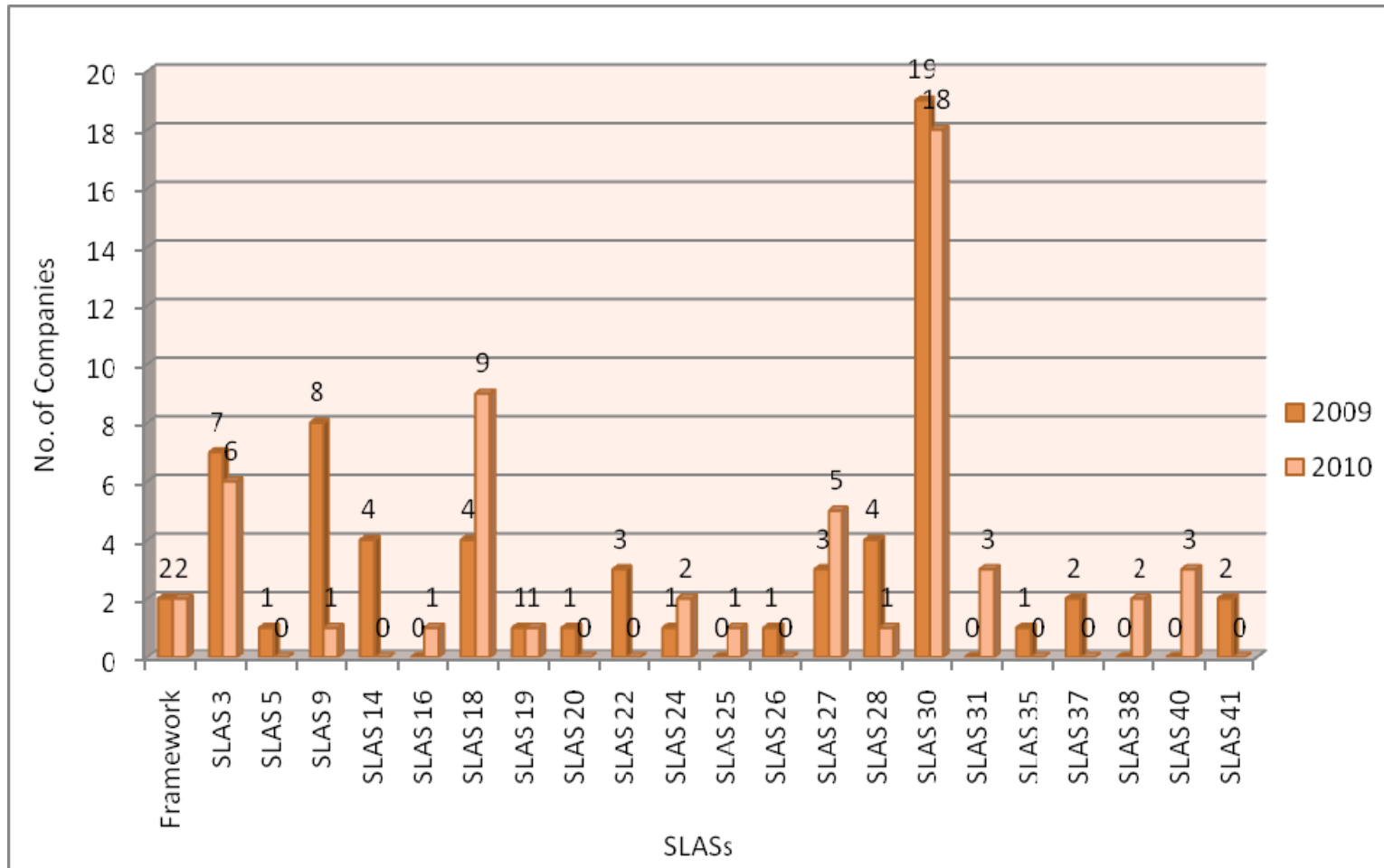


ANNEX 2

Non Compliance with CSE Listing Rules



ANNEX 3 Comparisons of SLAS Violations



ANNEX 4 Violations as a % of Sector Wise Total No. of Companies

