Exposure Draft of the Code of Best Practice

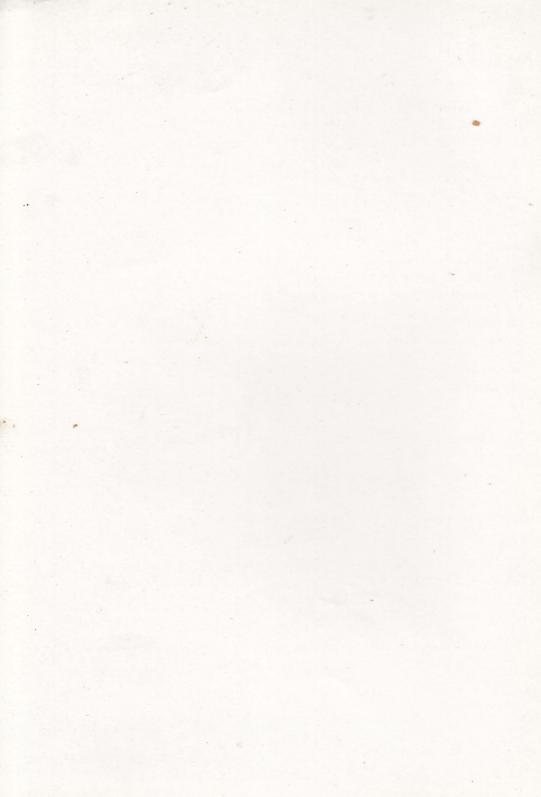
The initiation of change and invitation to debate

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REPORT OF THE COMMITTEE

TO MAKE RECOMMENDATIONS
ON MATTERS RELATING TO FINANCIAL ASPECTS
OF CORPORATE GOVERNANCE







This Exposure Draft is being published by the Committee to make recommendations on matters relating to financial aspects of Corporate Governance. It is published for the purposes of debate and discussion. This Exposure Draft is a Consultation document. The intention of this publication is to enable all interested persons to have an opportunity to see whether the preliminary conclusions we have reached, are appropriate.

The Committee hopes to consider the representations by all interested parties before the finalisation of its Report which they hope to complete and forward to the Council of the Institute of Chartered Accountants of Sri Lanka by early December 1997.

Accordingly, the Committee would be pleased to receive representations from any interested party upto 15th October 1997.

All representations and correspondence relating to the Exposure Draft should be addressed to:

The Secretary

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C/o. Institute of Chartered Accountants or Sri Lanka

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Any persons or representatives of Organisations who wish to make oral representations are invited to contact the Secretary of the Committee so that a suitable opportunity for such persons to meet the Committee Members could be arranged.

Additional copies of this Exposure Draft could also be obtained from the Secretary of the Committee at a price of Rs. 50/- per copy.

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MESSAGE FROM THE PRESIDENT, INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

It gives me immense personal satisfaction to send this message to accompany the publication of the Exposure Draft of the Code of Best Practice on the Financial Aspects of Corporate Governance.

The need for such a Code has been discussed in business circles for sometime. The Institute as the official body vested with the power of setting Accounting and Auditing Standards was of the view that a Code of Best Practice on Financial Aspects of Governance was an important corollary to the task of Standards setting as they will complement each other in producing excellence in financial reporting in Sri Lanka.

Accordingly the Council appointed a Task Force of carefully selected individuals representing the different users and regulators of financial reports. Mr. Nivard A.L.Cabraal a distinguished Past President of the Institute was invited to head the Task Force.

True to its eminent composition the Task Force has indeed produced an impressive document based on the extensive comments received from its constituency. Some of the draft recommendations are already being discussed positively in various interested sectors and will I am sure, be well received.

I am aware that the Task Force intends to conduct a workshop to explain in more detail the rationale for its recommendations, during the comment period and hopes to finalize the Code later this year.

I take this opportunity to thank the Chairman and Members of the Task Force for their commitment and dedication in developing this comprehensive document.

M. Reyaz Mihular
PRESIDENT
Institute of Chartered Accountants of Sri Lanka.
Colombo, 15th August 1997.

PREFACE TO THE EXPOSURE DRAFT

In March 1996, the Council of the Institute of Chartered Accountants of Sri Lanka decided to set up a Committee to make recommendations on matters relating to Financial Aspects of Corporate Governance.

The terms of reference for such Committee was agreed as follows:

To consider, in the context of financial reporting and accountability in Sri Lanka, and make recommendations on appropriate amendments to the relevant statutes and good practice, in relation to the following issues:

- the responsibilities of executive and non-executive directors for reviewing and reporting on corporate performance, with particular reference to such performance expressed in financial terms to shareholders and other financially interested parties;
- the case for audit committees of the company, including their composition and role;
- the responsibilities and liability of statutory auditors and the extent, scope and value of the aunat;
- the links between shareholders, boards and statutory auditors;
- any other relevant matters.

Corporate Governance which is popularly understood to be the system by which Companies are directed and controlled, has been an issue which has resulted in a great deal of comment and debate over the past few years all over the world. In Sri Lanka, the impact of the **Cadbury Committee's** report in UK has been felt, and several companies which are listed in the Colombo Stock Exchange already follow some of the recommendations contained therein as well as some subsequent reports on Corporate Governance prepared in the UK and some other countries.

At a time when Sri Lanka's own Stock Exchange is showing greater maturity and growth, it seems timely that Sri Lanka too should



critically examine the issues relating to Corporate Governance and develop suitable responses. Hence the initiative taken by the Institute of Chartered Accountants of Sri Lanka in keeping with one of its stated goals, namely, that of contributing in a significant manner to the national development effort, to set up our Committee is a laudable one and the Institute should be congratulated for such initiative.

Our Committee's work was greatly facilitated by the close co-operation we received from the ICASL, particularly from the President, Mr. M. Reyaz Mihular and the Secretary to our Committee, Mr. D. B. Andarawewa, and on behalf of the Committee, I wish to thank them very sincerely.

This Committee comprises of persons who are drawn from the many organisations and bodies which have a significant impact and influence on the development of Sri Lanka's stock market, and they also represent a wide cross section of the interested parties in the subject of Corporate Governance. The fact that they have participated actively in the formulation of this Exposure Draft is matter of satisfaction and encouragement.

In order to ascertain the views of as many interested parties as possible, the Committee invited **public comment through a rather detailed questionnaire.** Thereafter, it was able to formulate this Exposure Draft, taking into consideration many of the suggestions, comments and ideas submitted by those persons who responded. On behalf of the Committee I wish to place on record our sincere appreciation of all efforts of those interested parties. Their contributions helped us a great deal and I am sure the Committee looks forward to their as well as others' further responses to this Exposure Draft in the near future.

It should be emphasised that the preliminary conclusions set out by us in this Exposure Draft are not cast in stone. The Draft is in fact a consultation document. The intention is that all interested parties will have yet another opportunity to examine whether the preliminary conclusions reached by us, and the initial recommendations made by us are appropriate.

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The Committee also hopes to organise **public seminars**, in addition to inviting direct representations from those interested with regard to the matters referred to in this Exposure Draft, and any further issues they may wish to submit for the consideration of the Committee. Those representations would be given due consideration before the formulation of the final report. We recognise that it is through such comments and suggestions that our **report could be improved and made more effective and practical**, so that thereby our recommendations will have greater acceptance within the business, professional and academic community of our country.

Ideally, I would like to see the final recommendations arising from our report being categorised as follows, after the gestation period suggested by the Committee.

- (a) Possible amendments to the Securities and Exchange Commission Act
- (b) Possible amendments to the rules and regulations of the Colombo Stock Exchange.
- (c) Possible amendments to the Companies Act
- (d) Possible amendments to the ICASL Act
- (e) A Code of Best Practice, as applicable to all listed Companies.

In this connection, it would have to be carefully considered as to whether the recommendations of the Committee in relation to the courses of action to be followed by Directors, Auditors and Shareholders should be made **mandatory or voluntary**. The unfortunate experience in Sri Lanka has been that it is rarely that people follow desirable but non-mandatory requirements. In that background, it may be necessary to insist on the mandatory compliance of at least certain key practices, perhaps after allowing a reasonable grace period to study the impact of voluntary compliance. It is conceded that certain Companies although listed, are relatively small in the scale of operations, and maybe, such companies have to be permitted a longer grace period to fall in line, or even an exemption from certain requirements, depending upon the



circumstances. Such issues too, would have to be worked out in the future.

Another factor that the Committee would have to give further attention in the future is **whether the Code of Best Practice should function on a "framework" basis or as a detailed rule book.** Here again, a "middle path" may be the likely option to follow where certain best practices are set out as detailed guidelines, while others are set out on a broad "framework" basis. Whilst there may be great benefit in achieving consistency and uniformity through the following of pre-set norms, there are occasions (especially in the case of new initiatives similar to the proposals contained in this Report), where the setting out of detailed norms, may cause undue hardship and/or unnecessary confusion. Hence, our Committee would have to give careful consideration to such issues as well, in the finalisation of the Code.

It may sometimes be seen that the corporate regulatory system has many involved regulatory and semi-regulatory organisations, sometimes working in rather rigid water-tight compartments. These authorities [eg. the SEC, CSE, Registrar of Companies, Sri Lanka Accounting & Auditing Standards Monitoring Board, the Accounting Standards Committee of ICASL, the Auditing Standards Committee of the ICASL, the Urgent Issues Task Force of the ICASL] should have a clear understanding of the overall objectives of regulation, and also attempt to **infuse an element of congruence** within their respective activities. That would be a very desirable outcome and we are hopeful that the setting out of a Code of Best Practice of this nature would lead to a greater degree of congruence and understanding within the above stated organisations.

Having in place the Laws, Rules, Standards and Codes, whilst being very desirable is not sufficient for the **enhancement of confidence in the system.** The proper and **effective enforcement** of such Laws, Rules and Standards and the ready acceptance of the code by all relevant parties is an equally vital requisite especially in an emerging stock market, such as ours. Hence a great deal of attention would naturally have to be paid to the factors involved in the **overall enforcement** of the suggested proposals. If not, a situation where the very Companies whose governance needs improving and are consequently the ones who are not

complying with the provisions as recommended, would not be discovered soon enough, with probable disastrous results. The Sri Lankan economy could very well do without such set backs. Hence I believe it would be another responsibility of the Committee, and the ICASL of follow up closely on the final recommendations and ensure its proper and timely implementation. Otherwise, all our efforts would have been in vain.

Our Committee is deeply conscious of the fact that the Sri Lankan Stock Market is an emerging one and should be nurtured carefully so that it may realise its full potential. In order to achieve this, the business environment must be conducive for growth and sustainability. Hence, through our Code, the aim is to provide a framework within which business can prosper and grow. Without prospering and growing business, we have no governance, we have no stakeholders, we have no auditors, we have no directors, we have nothing.

Particularly in that context, some may view this Code of Best Practice covering the financial aspects of Corporate Governance as yet another piece of regulation which serves as an irritant to the "quick growth" of the market, as a result of new entrants seeking listings shying away from obtaining a listing due to "excessive" requirements being imposed. On the other hand, it may also be argued that long term investors would be more likely to invest in a market which has a solid foundation in financial reporting and corporate governance and is properly regulated since they would in such circumstances consider their investment to be in a well regulated environment. The challenge therefore, is to strike a balance between these two propositions and have a satisfactory mix of "freedom" and "regulation" which encourages both the steady growth of Companies as well as the steady build up of confidence of investors. Towards that healthy objective, whatever initiatives that could be promoted by the respective regulatory authorities and connected agencies would be, we are sure, welcome.

For clarity, I would therefore like to emphasise once again the fundamental that lies behind all our deliberations: **We must not stifle**; **we must stimulate.**



The next 2 to 3 months would be used by the Committee to review, revise and finalise this Report. Hopefully, once the responses to the Exposure Draft are considered and carefully evaluated, an even clearer picture would emerge, and all issues that need to be addressed would find its' way into the final Code of Best Practice.

Our Committee now eagerly look forward to your responses, with the assurance that those would be considered with a great deal of interest and seriousness.

Nivard A. L. Cabraal

Chairman,

Committee to make recommendations on matters relating to financial aspects of Corporate Governance.

Colombo, 15th August 1997.

REPORT OF THE COMMITTEE TO MAKE RECOMMEN-DATIONS ON MATTERS RELATING TO FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

1. INTRODUCTION

1.1 The Background to the Report

- **1.1.1** The country's capital market development depends, inter-alia on the **drive and efficiency** of its companies. Thus the effectiveness with which their Boards discharge their responsibilities determines, to a great extent, Sri Lanka's competitive position.
- **1.1.2** The Boards must be free to drive their Companies forward, but exercise that **freedom within a framework of effective Accounta bility.** This is the essence of any system of good Corporate Governance.
- 1.1.3 Like in many other countries, Sri Lanka too, has witnessed in the recent past, failures of Companies, especially Finance Companies with no one being prepared to take the responsibility for such failures. Many reasons have been attributed for such failures. These failures resulted in many investors losing faith in the regulatory and semi-regulatory framework, as well as in the standards of financial reporting, and this situation almost reached crisis proportions at a certain time. Fortunately, timely intervention by the concerned regulatory and semi-regulatory authorities resulted in the storm being weathered, but the underlying causes for the failures needed to be addressed on a fundamental basis, urgently and decisively.
- **1.1.4** In January 1992, the Institute of Chartered Accountants of Sri Lanka took the preliminary steps to institutionalize a scheme whereby the application of Sri Lanka Accounting Standards could be monitored and enforced. To implement such scheme, the Institute at that time, set up a Task Force consisting of several senior members and representatives of Public and Private Institutions, to look into the issues relating to the enforcement of the Sri Lanka Accounting Standards, and such Task Force recommended the setting up of an "Accounting Standards Monitoring Unit". This proposal was forwarded to the Government in April 1993

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which in turn was referred to the Financial Sector Reform Committee, which accepted same. This finally resulted in the Government enacting the present Sri Lanka Accounting and Auditing Standards Act No. 15 of 1995. This Act as we are aware, has empowered the ICASL to issue Sri Lanka Accounting and Auditing Standards and also provided for the setting up of an independent Sri Lanka Accounting and Auditing Standards Monitoring Board.

1.1.5 Under the Sri Lanka Accounting and Auditing Standards Act No. 15 of 1995, the Sri Lanka Accounting and Auditing Standards Monitoring Board was established to monitor the compliance of Sri Lanka Accounting and Auditing Standards promulgated by the Institute for specified enterprises as set out in the Act.

This initiative has been hailed as a significant development in the field of financial reporting, and no doubt, goes a long way in instilling confidence in investors and stock market intermediaries in the **enhancement** of the quality of financial reporting in Sri Lanka.

- **1.1.6** Another significant initiative that was taken by the ICASL was the setting up of an **Urgent Issues Task Force**, **(UITF)** in March 1993 with a mandate to provide clarification and interpretations of the Sri Lanka Accounting Standards. Today, the UITF is perceived by the business and financial community as a useful body in promoting the understanding and application of the Sri Lanka Accounting Standards and its rulings are accepted as quasi Standards, particularly where the Standard itself is not clear on a particular issue.
- **1.1.7** The Committee notes that the Institute of Chartered Accountants of Sri Lanka was established under Act No. 23 of 1959 and is the premier National Body of Accountants in Sri Lanka today. The **Institute's Corporate Plan** sets out as one of its key strategies, its contribution to 'Capital Market Development', with the particular action being to:
- "(a) Contribute the Institute's knowledge, skills and expertise in the Capital Market Development effort contributing actively to it's policy formulation through the Securities and Exchange Commission of Sri Lanka and other relevant Agencies/Bodies.

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- (b) Liaise with relevant agencies in developing policy to attract local and foreign investment into the country."
- **1.1.8** The Committee also notes that the ICASL's decision to set up our Committee was prompted by its intention to provide leadership in the setting up of an effective system of good Corporate Governance, and that the ICASL thereafter intends to take the necessary steps together, and in consultation with, the Government and other relevant agencies, to implement such proposals. Our Committee commends such strategy.
- **1.1.9** The Committee also notes with satisfaction that, "the ICASL believes that the recommendations of this Committee would serve as a very useful **starting point to improve corporate governance** in public companies and will consequently contribute in a significant manner to the overall development of the capital market in this country. Such a course of action would also be in keeping with the Institute's declared mission which reads as, "To be the premier national body of Accountants committed to serving society by promoting and developing accountancy expertise towards resource management at the highest levels of integrity and competence."

In the interest of Sri Lanka's stock market, we hope that our report will serve that useful purpose.

- **1.1.10** The **Members of the Committee** appointed by the Institute, are composed of key personnel from various sectors. Their Names and Positions appear in Annexe 1.
- **1.1.11** The **Terms of Reference** of the Committee is set out in Annexe 2.

1.2 The Concept of Corporate Coverance

1.2.1 The dictionary definition of "Governance" is both "the action or manner of governing" and "mode of living, behaviour, or demeanour".

Our understanding of Corporate Governance reflects these two perspectives in that, in considering Corporate Governance practices in each



jurisdiction, one has to focus on the processes used to direct and manage the business and affairs of a Company with the object of balancing:

- the attainment of corporate objectives
- the alignment of corporate behaviour with the expectations of society.
- the accountability to the owners (shareholders).

Corporate Governance is popularly understood as the system by which Companies are directed and controlled. Boards of Directors are responsible for the Governance of their Companies. The Shareholders' role in Governance is to appoint the Directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the Board include the setting out of the Company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship.

Therefore, the processes of corporate governance involves:-

- responsibilities who should do what?
- accountability to whom should those with irresponsibilities account? and how?
- checks and balances the system of supervision and control procedures and communication flows.
- **1.2.2** The Committee is of the view that awareness of Corporate Governance should be disseminated among all interested parties in Sri Lanka. This could be done by conducting Seminars and Work-shops at regular intervals, perhaps by the ICASL jointly with the Regulatory Bodies, and other connected institutions.
- **1.2.3** The Committee's overall objective is to activity assist and encourage the raising of the level of Corporate Governance in Sri Lanka and consequently the level of confidence in financial reporting and auditing, by setting out clearly what it sees as the respective responsibilities of those involved and what is expected of them.

1.3 The Methodology adopted by the Committee

- **1.3.1** Initially, the Committee studied the **reports published in other countries** on this subject, especially the Cadbury Report and developed a questionnaire which was, to some extent based on the areas covered in the Cadbury Report, suitably modified to the local environment.
- **1.3.2** The **Questionnaire** was issued to all Listed Companies, Audit Firms, Regulatory Bodies such as Securities and Exchange Commission of Sri Lanka, Colombo Stock Exchange, and the Registrar of Companies, Central Bank of Sri Lanka, Department of Inland Revenue, Chartered Institute of Management Accountants, Sri Lanka Division, Institute of Chartered Secretaries and Administrators in Sri Lanka, Chartered Association of Certified Accountants, Sri Lanka Branch, and others. The Committee also **invited comments from the general public** on the Questionnaire through public advertisements.
- **1.3.3** The Committee received written representations to the Questionnaire from different Sectors and noted that a large majority of those who responded, broadly supported and endorsed the Committee's approach.

The Committee is grateful to all those who took the time and effort to give us their comments. These comments have been very useful and has helped the Committee immensely in the preparation of this Report. The names of those who responded appear in Annexe 3.

1.4 Report Content

- **1.4.1** The Report while reviewing the structure and responsibilities of the Board of Directors, makes recommendations which would constitute a Code of Best Practice. It also considers the role of the Auditors and makes certain recommendations. The recommended role for the shareholders is also covered.
- **1.4.2** Initially, perhaps for a period of one or two years, the **Committee encourages voluntary compliance** of its Recommendations by all Listed Companies, Unit Trusts, Fund Management Companies, Finance Companies, Banks, and Insurance Companies. The **Committee also**



recommends that in due course, appropriate action be taken by the Council of the ICASL to approve the report and submit its recommendations to relevant governmental authorities and other relevant institutions, for further action. This is best done after studying the impact of the recommendations on the companies to which it is directed, and after making suitable modifications, if unforseen and / or complex problems develop in the implementation of same.

2. THE IMPLEMENTATION PROPOSALS FOR THE CODE OF BEST PRACTICE

2.1 Companies to whom directed

The **Committee recommends** that the Code of Best Practice be directed to the Boards of Directors of all Listed Companies registered in Sri Lanka and others as set out in para 1.4.2. The Committee recommends that other Companies wherever possible, attempt at meeting these requirements, in the interest of their own shareholders.

2.2 Compliance with the Code

- **2.2.1** Once the Code is in place, the **Committee recommends** that all Listed Companies and others to whom it is directed make a statement setting out the status of their compliance with the Code, in the Annual Report and Accounts and give reasons for any areas of non-compliance.
- **2.2.2** The **Committee recommends** that all parties concerned with good and effective Corporate Governance, should use their influence to encourage compliance with the Code.
- **2.2.3** The **Committee recommends** that the Shareholders, particularly the institutional investors, should use their influence as owners to ensure that Companies in which they have invested, comply with the Code.

2.3 Need to make amendments to existing statutes.

The **Committee recommends** that appropriate amendments to existing statutes, rules and regulations be introduced by the Government and the relevant regulatory authorities, to give effect to the provisions of the Code, once it is finalised and accepted; and after the suggested gestation period has elapsed.



3. THE BOARD OF DIRECTORS

3.1 The Effectiveness of the Board

- **3.1.1** Every Public Company should be headed by an **Effective Board** which can both lead and control the business. Such a Board can definitely bring value to its shareholders.
- **3.1.2**The Committee emphasises the importance of the "performance functions" of the independent Non-Executive Directors and their role as advisors to the Board, particularly by assisting the Board to resolve conflicts as they are less directly affected. Therefore, the Board's effectiveness can be achieved by a combination of Executive Directors with their intimate knowledge of the business and of "out-side" Non-Executive Directors who can bring a broader view to the Company's activities.

3.2 The Chairman

- **3.2.1** The Chairman's role in securing Good Corporate Governance is crucial. The Chairman is expected to preserve order, ensure that proceedings at meetings are conducted in a proper manner, and to ascertain the sense or decision of the meeting on the issues being discussed.
- **3.2.2** In the context of good corporate governance, the Chairman would be reasonably expected to ensure that all directors, executive and non-executive alike, are encouraged to play a useful role within their respective capabilities in order to secure the maximum benefit to the Company. It is also desirable that the Chairman is not involved in the day-to-day operations of the Company, but operates in such a way so as to ensure that the Board is in complete control of the Company's affairs and fully alert to the obligations towards the shareholders.
- **3.2.3** In our view, it would also be the responsibility of the Chairman to make certain that the non-executive directors receive timely and relevant information on all issue so that they are properly briefed on all matters arising at board meetings, thus ensuring that they make effective contributions to the Board's deliberations.

- **3.2.4** Considering therefore the wide responsibility cast upon the Chairman, we consider it a **desirable practice that this position should be separated from that of the Chief Executive.** This is mainly to avoid the domination of power by a single individual.
- **3.2.5** Therefore, the **Committee recommends** that there should be a clearly accepted division of responsibilities at the Head of a Company to ensure a balance of power and authority.

3.3 Non-Executive Directors

- **3.3.1** The essence of Non-Executive Directors is to bring **expertise in the different fields** to the Board, so that they could advise the Board independently. Therefore, an essential quality which a Non-Executive Director should bring to the Board, in the Board's deliberations is that of **independent judgement.** Non-Executive Directors may include the following:
- (a) Those representing Shareholders with substantial shareholderings.
- (b) Persons specialized in such fields as Finance, Law, Information Technology, Marketing, Engineering, Human Resources Management, etc.
- **3.3.2** In all such instances, the persons so appointed as non-executive directors should be widely accepted as being persons of honesty and integrity. The non-executive directors would also be expected to advise the Board on matters relating to their areas of expertise.
- **3.3.3** The **Committee recommends** that the calibre and number of Non-Executive Directors on a Board should be such, that their views will carry significant weight in the Board's decisions.
- **3.3.4** The **Committee recommends** that Non-Executive Directors should be appointed for a specified period, since this will encourage the infusion of fresh thinking and also ensure that the non-executive directors do not lose their independence by continuing for unlimited periods of time.



3.3.5 The **Committee recommends** that their appointments should be a matter for the Board as a whole, and their selection process should be based mainly on merit and not through any form of patronage.

3.4 Professional Advice

The Committee notes that occasions may arise where Directors have to seek legal or financial advice in the furtherance of their duties. Since it is done in the interest of the Company as a whole, the **Committee recommends** that expenses of such consultation and advise be borne by the Company, subject to prior approval of the Board. The **Committee recommends** that this be included in the letter of appointment of a Director as a condition.

3.5 Directors' Training

- **3.5.1** It is always beneficial to a Company when its' Directors have a basic knowledge in other areas other than their own field of expertise, as such a situation would contribute to a great extent in arriving at good decisions.
- **3.5.2** The **Committee recommends** that a formal and basic training be undertaken by the all Directors, in such fields as Financial Management, Entrepreneurship, Management, Corporate Planning, etc.
- **3.5.3** The Committee is aware of the constraints in conducting appropriate courses for the Directors by the Company itself. Therefore, the **Committee recommends** that in addition to short "in-house" training, institutions such as SEC, CSE, ICASL, CIMA, NIBM, PGIM, etc., be encouraged to conduct appropriate courses and workshops for Directors.

3.6 Committee Structures for Boards

The effectiveness of a Board depends on its structure and procedures. Some aspects of such structures would be the appointment of Committees such as the Audit Committee and the Remuneration Committee. The **Committee recommends** that procedures be laid down for the functioning of such Committees.

3.7 Audit Committees

- **3.7.1** The **Committee recommends** that all listed companies should establish an Audit Committee and our recommendations regarding the setting up of such Audit Committees are as follows;
- (a) The Audit Committee should be appointed by, and be accountable to, the Board.
- (b) The Audit Committee should have specific Terms of Reference set out by the Board.
- (c) Membership of the Audit Committee should not be open to any Executive Directors, and should be chaired by a Non-Executive Director. Executive Directors may however attend meetings on invitation..
- (d) The Audit Committee should have an explicit authority to investigate any matters within its' Terms of Reference.

3.7.2 As described lucidly in the Cadbury Committee Report:

"If they operate effectively, audit committees can bring significant benefits. In particular, they have the potential to:

- (a) improve the quality of financial reporting, by reviewing the financial statements on behalf of the Board;
- (b) create a climate of discipline and control which will reduce the opportunity for fraud;
- (c) enable the non-executive directors to contribute an independent judgement and play a positive role;
- (d) strengthen the position of the external auditor by providing a channel of communication and forum for issues of concern;
- (e) provide a framework within which the external auditor can assert his independence in the event of a dispute with management;
- (f) strengthen the position of the internal audit function, by providing a greater degree of independence from management;"



- **3.7.3** The Committee believes that the appointment of a separate Audit Committee enables the Board to delegate to the Committee a thorough and detailed review of audit matters. This would enable the Non-Executive Directors to exercise their independent judgement and play a positive role for which they are particularly suited.
- **3.7.4** The following paragraphs, which appear in Appendix 4 of the Cadbury Report sets out certain norms regarding the setting up and functioning of Audit Committees, and the **Committee recommends** that such norms be followed in Sri Lanka as well.
- **3.7.4.1** "The effectiveness of audit committees will be reduced, however, if they act as a barrier between the auditors and the executive directors on the main board of if they encourage the main board to abdicate its responsibilities in the audit area, so weakening the board's collective responsibility for reviewing and approving the financial statements. They will also fall short of their potential if they lack the understanding to deal adequately with the auditing or accounting matters that they are likely to face, if they remain under the influence of any dominant personality on the main board, or if they simply get in the way and obstruct executive management and stifle entrepreneurial skills.
- **3.7.4.2** Audit committees will be as good as the people on them; effectiveness depends crucially on a strong, independent Chairman who has the confidence of the board and of the auditors, and on the quality of the non-executive directors. Structure is also important, however, and adherence to the following recommendations will ensure that audit committees are soundly based.
- (a) Audit committees should be formally constituted as sub-committees of the main board to whom they are answerable and to whom they should report regularly; they should be given written terms of reference which deal adequately with their membership, authority and duties; and they should normally meet at least twice a year.
- (b) There should be a minimum of three members. Membership as stipulated above should be confined to the non-executive directors of the company and a majority of the non-executives serving on the committee should be independent of the company. This means that apart

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from their directors' fees and shareholdings, they should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement as a committee member. It is for the board to decide in individual cases whether this definition is met.

- (c) The external auditor and where an internal audit function exists, the head of internal audit should normally attend audit committee meetings, as should the finance director. Other board members should also have the right to attend.
- (d) The committee should have a discussion with the auditors, at least once a year, without executive board members present, to ensure that there are no unresolved issues of concern.
- (e) The audit committee should have explicit authority to investigate any matters within its terms of reference, the resources which it needs to do so, and full access to information. The committee should be able to obtain outside professional advice and if necessary to invite outsiders with relevant experience to attend meetings."
- **3.7.6** The Committee reiterates that the ultimate responsibility of the Board for reviewing and approving the Annual Report and Accounts remains undiminished by the appointment of an Audit Committee, but it provides an assurance that a key area of the Board duties will be rigorously and diligently discharged.

3.8 Remuneration Committee

The **Committee recommends** that the Board appoints a "Remuneration Committee" to recommend to the Board the remuneration of the Executive Directors. The Remuneration Committee should be composed of both Executive and Non-Executive Directors and it should be chaired by a Non-Executive Director. The **Committee recommends** that the names of the members of the Remuneration Committee should appear in the Annual Report.



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3.9 Finance Director

The **Committee recommends** that the finance function of the Company is made the responsibility of a specific Board Director.

3.10 Director's Responsibility for the Preparation of Financial Statements

3.10.1 The **Committee recommends** that the Annual Report should include a statement regarding the Directors responsibilities for the Financial Statements in the Annual Report.

The purpose of this is to make clear that responsibility for preparing the financial statements rests with the Board of Directors and to remove any conception that the auditors are responsible for same. The directors' statement should be placed immediately before the Auditors' report.

- **3.10.2** The explanation of directors' responsibilities should ideally cover the following points:
- (a) the responsibility of the directors for maintaining adequate records for safeguarding the assets of the Company and for preventing and detecting fraud and or other irregularities.
- (b) Confirmation that the applicable Sri Lanka Accounting Standards have been followed, subject to any material departures disclosed and explained in the notes to the accounts, as provided for in the preface to the Sri Lanka Accounting Standards.
- (c) Confirmation that suitable accounting policies consistently applied and supported by reasonable and prudent judgements and estimates have been applied in the preparation of the financial statements.
- **3.10.3** This statement should also be used for reporting that the Directors have maintained an effective system of internal control and that the business is a going concern with supporting assumptions or qualifications as necessary.

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3.10.4 It should however be noted that such statement does not obviate the need for a formal statement in the notes to the accounts disclosing whether the accounts have been prepared in accordance with the applicable Sri Lanka Accounting Standards.

3.11 Internal Control

The Committee is of the view that an effective Internal Control system is an essential part of the efficient management of a Company. The **Committee recommends** that the Directors should make a specific statement in the Annual Report on the effectiveness of the Company's system of Internal Control.

3.12 Company Secretary

Regulations made under the provisions of the Companies Act sets out the minimum qualifications of the Company Secretary. The **Committee recommends** that this requirement be continued. The Committee expects the Company Secretary to be a source of advice to the Chairman and to the Board on the implementation of the Code of Best Practice re. Corporate Governance as well.

3.13 Conduct of Board Members and Employees

It is important that all Board Members and employees should know what standards of conduct are expected of them. The **Committee recommends** that the Boards of Directors draw up Codes of Ethics and Statements of Business Practices for Board Members and employees and publish them both internally and externally.

3.14 Chairman / Chief Executive's Review

The Committee emphasises the necessity for the Chairman's / Chief Executive's Review to cover in reasonable detail, the performance of a Company during the past year. The **Committee recommends** that such review should also cover future prospects of the activities of the Company in the ensuing year and at least over the next two years.



4. AUDIT

4.1 Effectiveness of External Audit

The Committee is of the view that the External Audit, if properly carried out according to the Sri Lanka Auditing Standards, would lead to the expression of an objective, independent and effective opinion on the Financial Statements.

4.2 Awareness of the Sri Lanka Accounting and Auditing Standards Act.

4.2.1 The Committee notes with satisfaction, the additional responsibilities cast on certain categories of Companies under the provisions of the Sri Lanka Accounting and Auditing Standards Act No. 15 of 1995, wherein a Sri Lanka Accounting and Auditing Standards Monitoring Board has been established to monitor compliance with the Sri Lanka Accounting and Auditing Standards in the preparation, presentation and audit of Financial Statements. Therefore, the Committee is of the view that Boards of Directors should be made aware of the importance of the application of Sri Lanka Accounting and Auditing Standards.

4.2.2 The Committee is of the view that at present, Boards of Directors have a fair understanding of the responsibilities and duties of the statutory auditors. However, at times, this understanding may be incomplete, and hence the **Committee recommends** that the Institute of Chartered Accountants of Sri Lanka and other relevant institutions conduct Seminars and work-shops for Board Directors and other relevant employees of Companies regarding the importance and application of Sri Lanka Accounting and Auditing Standards, and the scope of the audit and other opinion-related work.

4.3 Audit Fees

The **Committee recommends** that the fees paid for audit and non-audit work be shown separately in the Annual Report.

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4.4 Rotation of Auditors

- **4.4.1** The **Committee recommends** the periodical rotation, (which rotational period should not exceed 5 years) of the audit partners and staff within the same firm of External Auditors, in the carrying out of a Company's audit.
- **4.4.2** The **Committee recommends** that a second partner reviews the basis on which the audit opinion was expressed.

4.5 Going Concern

Generally, Financial Statements are prepared on the assumption that the Company is a Going Concern. In view of the failure of large number of Companies, the **Committee recommends** that the Directors include a statement indicating that they are satisfied about the Company being a Going Concern. For this purpose, the period is suggested as one year from the date of the Balance Sheet, or six months from the date of signing of the financial statements, which ever is later.



5. CONCLUSION

- **5.1** The committee is deeply conscious of the fact that the Sri Lankan Stock Market is an emerging one and should be nurtured carefully so that it may realise its full potential. In order to achieve this, the environment must be conducive for growth and sustainbility.
- 5.2 In that context, some may view this Code of Best Practice covering the financial aspects of Corporate Governance as yet another piece of regulation which serves as an irritant to the "quick growth" of the market as a result of new entrants seeking listings shying away from obtaining a listing due to "excessive" requirements being imposed. On the other hand, it may be argued that long term investors would be more likely to invest in a market which has a solid foundation in financial reporting and corporate governance and is property regulated since they would in such circumstances feel more comfortable as they consider their investment to be in a well regulated environment. The challenge therefore, is to strike a balance between these two propositions and have a satisfactory mix of "freedom" and "regulation" which stimulates both the steady growth of Companies as well as the steady build up of confidence of investors. Towards that healthy objective, whatever initiatives that could be promoted by the respective regulatory authorities and connected agencies, would be welcome.
- **5.3** Our committee views the recommendations set out in our report as being initiatives which would certainly promote the achievement of the abovementioned objective and are confident that, over time, it would have the desired effect of stimulating the stock market and business in Sri Lanka.

We are also confident that these initiatives would enhance the levels of Corporate Reporting, Auditing systems, and Board effectiveness in the Sri Lankan environment, all of which would further instill confidence and thus foster the growth and sustenance of Colombo's Stock Market.

5.4 As we are aware, the physical infrastructure facilities available for share trading, within the Colombo Stock Exchange has now been upgraded to a very high level. Such infrastructure, coupled with an

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effective and practical financial reporting and regulatory system would certainly fuel the rapid growth of the Colombo Stock Market making it one of the major stock markets in South Asia with universal acceptance by investors from all over the world.



6. SUMMARY

- **6.1** The Committee identified Corporate Governance as the system by which Companies are directed and controlled. Boards of Directors are responsible for the Governance of their Companies. The Shareholders' role in Governance is to appoint the Directors and the Auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the Board include the setting out of the Company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship.
- **6.2** Initially, the Committee studied the reports published in other countries on this subject, especially the Cadbury Report and developed a questionnaire which was, to some extent based on the areas covered in the Cadbury Report, suitably modified to the local environment. The Committee received many representations to the Questionnaire from different sectors.
- **6.3** The Report, while reviewing the structure and responsibilities of the Board of Directors, makes recommendations in the form of a Code of Best Practice. It also considers the role of the Auditors and makes certain recommendations. The recommended role for shareholders is also covered.
- **6.4** Perhaps for a period of one or two years, the Committee encourages voluntary compliance of its recommendations by all Listed Companies, Unit Trusts, Fund Management Companies, Finance Companies, Banks and Insurance Companies. The Committee recommends that in due course, appropriate action be taken by the Council of the ICASL to approve the report and submit its recommendations to relevant governmental authorities and the relevant institutions, for further action.

6.5 Summary of Recommendations

The Committee recommends that:

- The Code be directed to all listed Companies, Unit Trusts, Fund Management Companies, Finance Companies, Banks and Insurance Companies.
- Other Companies too be encouraged to follow the provisions of the Code.
- All Listed Companies and others to whom the Code is directed, make a statement setting out the status of their compliance with the Code.
- All parties concerned with good and effective Corporate Governance, use their influence to encourage compliance with the Code.
- Appropriate amendments to existing rules and regulations be introduced by the Government and the relevant regulatory authorities to give effect to the provisions of the Code after it is finalised and accepted, and after the suggested gestation period.
- There should be a clearly accepted division of responsibilities at the Head of a Company to ensure the balance of power and authority.
- The calibre and number of Non-Executive Directors on a Board should be such that their views will carry significant weight in the Board's decisions.
- Non-Executive Directors should be appointed for a specified period.
- The appointment of Non-Executive Directors should be a matter for the entire Board.
- Expenses of individual Directors in obtaining professional advice to be borne by the Company subject to prior approval of the Board.
- Formal and basic training be undergone by all Directors so that they have a basic knowledge of other areas other than their own field of expertise.



- Short "in-house" courses to be organised by Institutions with capabilities to do so, for the benefit of Directors.
- Procedures be laid down for the functioning of Audit Committees and Remuneration Committees.
- All Companies to whom the Code is directed, establish audit committees as set out in the report.
- The Board should appoint the Remuneration Committee to report to the Board re, the remuneration of Executive Directors.
- Annual Reports should include a statement re. the Directors respon sibilities for the financial statements in the Annual Report and Financial statements.
- The Directors should make a specific statement in the Annual Report on the effectiveness of the Company's systems of internal control.
- The Board of Directors should draw up codes of ethics and statements of business practices for Board members as well as employees.
- The Chairman's Review should cover the performance of the Company during the past year, the future prospects in the ensuing year and at least for the next 2 years.
- The ICASL and other relevant institutions should conduct Seminars and Workshops for Board Directors and others re.the importance of the Sri Lanka Accounting and Auditing Standards and the scope of the audit and other opinion related work.
- The fees paid for audit and non-audit work be shown separately in the Annual Report.
- A periodical rotation of the audit partners and staff within the same firm of external auditors takes place at least once every 5 years.
- A second Partner reviews the basis on which the audit opinion was expressed.
- The Directors include a statement indicating that they are satisfied about the Company being a going concern.

7. ANNEXES

Annexe 7.1

THE COMMITTEE

The Committee's members as at 15th August 1997, were the following:

Chairman

Mr. Nivard A L Cabraal

Past President - ICASL, Past President - South Asian Federation of

Accountants;

Members

Mr. Mahendra Amarasuriya Deputy Chairman - Hayleys Ltd., and Chairman, Commercial Bank of Ceylon Ltd.

Mr. KT Chitrasiri Registrar of Companies

Mr. Romesh de Silva President's Counsel, President - Bar Association of Sri Lanka

Mr. S Easparathasan Senior Deputy Governor, Central Bank of Sri Lanka and Chairman, Sri Lanka Accounting and Auditing Standards Monitoring Board

Mr. Channa Gunasinghe Former Chairman, Ceylon Chamber of Commerce

Mr. Kumar Paul Director General, Securities and Exchange Commission of Sri Lanka

Mr. M R Mihular President, Institute of Chartered Accountants of Sri Lanka

Mr. Hiran Mendis Director General, Colombo Stock Exchange



Mr. Angelo Patrick

Past President CIMA - Sri Lanka Division; Divisional Representative on the CIMA Council in London

Mr. G C B Wijeyesinghe
Past President - ICASL, Senior Partner KPMG Ford Rhodes Thornton & Co.

Secretary

Mr. D B Andarawewa Director, International Relations, ICASL

The Committee wishes to thank the following persons who served in our Committee in the past:

Mr. Dylan Moldrich Director General, Colombo Stock Exchange

Mr. Arittha Wikramanayake
Director General, Securities and Exchange Commission of Sri Lanka

Annexe 7.2

The Terms of Reference for the Committee to make recommendations on matters relating to Financial Aspects of Corporate Governance, as set out by the ICASL is as follows:-

1. Background

1.1 One of the Goals as identified in the Institute's Corporate Plan - 1993 to 1997 is: To influence National Policy Formulation in areas related to the Accountancy Profession.

In this regard, the Corporate Plan sets out as follows, one of the key strategies in relation to Capital Markets Development:

- *Contribute the Institute's knowledge, skills and expertise in the Capital Market development effort, contributing actively to its policy formulation through the Securities and Exchange Commission of Sri Lanka and other relevant agencies/bodies.
- * Liase with relevant agencies in developing policy to attract local and foreign investment into the country.
- 1.2 The country's capital market development depends, inter alia, on the drive and efficiency of its companies. Thus the effectiveness with which their boards discharge their responsibilities determines, to a certain extent, Sri Lanka's competitive position. The Boards must be free to drive their companies forward, but exercise that freedom within a framework of effective accountability. This is the essence of any system of good corporate governance.
- 1.3 It is therefore, a vital necessity that there is such a framework is developed and implemented in Sri Lanka. This framework should cover the control and reporting functions of boards, the role of auditors, and in general the practices that would constitute sound and good Corporate Governance.
- 1.4 In the U.K., a similar framework was developed in December 1992, when the "Cadbury Committee" made it's recommendations on "The Financial Aspects of Corporate Governance", and this report served as the basis for



the future programmes in this regard in the U.K.The "Cadbury Committee" was chaired by Sri Adrian Cadbury, and composed of Members from the Accountancy Profession, the Bank of England, the Financial Reporting Council, the "Hundred-Group of Finance Directors", the Institutional Shareholders' Committee, the Law Society, and the London Stock Exchange.

1.5 It is therefore the intention of the Institute to provide leadership in this regard and set up a Committee to consider and report on all relevant aspects of Corporate Governance as may be applicable to Sri Lanka. Thereafter, the Institute would take the necessary steps, together and in consultation with the Government and other relevant agencies, to implement such proposals. Such a course of action would, certainly help the Institute "to contribute, in a significant manner, to the National Development effort".

2. Terms of Reference:

The terms of reference of the Committee will be as follows:

To consider, in the context of financial reporting and accountability in Sri Lanka, and make recommendations on appropriate amendments to the relevant statutes and good practice, in relation to the following issues:

- * the responsibilities of executive and non-executive directors for reviewing and reporting on corporate and financial performance, to shareholders and other financially interested parties;
- * the case for audit committees of the board, including their composition and role;
- * the principal responsibilities and liability of auditors and the extent and value of the audit;
- * the links between shareholders, boards and auditors;
- * any other relevant matters.

Note:

For greater clarity, the above terms of reference was subsequently amended as follows:-

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To consider, in the context of financial reporting and accountability in Sri Lanka, and make recommendations on appropriate amendments to the relevant statutes and good practice, in relation to the following issues:

- the responsibilities of executive and non-executive directors for reviewing and reporting on corporate performance, with particular reference to such performance expressed in financial terms, to shareholders and other financially interested parties
- the case for audit committees of the company, including their composition and role;
- the responsibilities and liability of statutory auditors and the extent, scope and value of the audit.
- the links between shareholders, boards and statutory auditors
- any other relevant matters

3. Composition of the Committee

In order to gain the acceptance of the entire business community and the relevant governmental agencies, the composition of the Committee should reflect a "pooling" of views of the interested parties to the above stated issues. Accordingly, the Committee shall comprise the following;

Chairman

Nivard A L Cabraal

Past President - ICASL, Past President - SAFA, Past Member - SEC, Past Chairman - Accounting Standards Committee ICASL., Past Chairman -Accounting Standards Monitoring Board Task Force.

Members:

Mahendra Amarasuriya

Deputy Chairman - Hayleys Ltd. and a Director of many listed Companies

KT Chitrasiri, Registar of Companies



Romesh de Silva

President's Counsel and well known senior legal counsel on Corporate affairs

S Easparathasan

Senior Deputy Governor, Central Bank of Sri Lanka

Channa Gunasinghe

Chairman, Ceylon Chamber of Commerce

Dylan Moldrich

Chartered Accountant and Director General, Colombo Stock Exchange

Angelo Patrick

Past President CIMA - Sri Lanka Division, and Divisional Representative on the CIMA Council in London.

G C B Wijeyesinghe

Past President - ICASL., Past President - OPA, Member - SEC, Past Chairman - Committee to revise the Code of Ethics of the ICASL, Senior Patner - KPMG Ford, Rhodes, Thornton & Co.

Arittha Wikramanayake

Director General, Securities and Exchange Commission of Sri Lanka

Ex-Officio:

The President of the Institute of Chartered Accountants of Sri Lanka, Mr. M R Mihular, will be an ex-Officio Member of the Committee

Secretary

D B Andarawewa

Director Administration of the ICASL

The Committee would be free to conduct its' affairs in any manner it sees fit and would be free to co-opt any person to contribute to its' deliberations. The Committee may also invite representations from any source in relation to its' terms of reference.

4. Funding

4.1 The Committee's activities would be funded by the Institute.

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4.2 The Committee Members will be reasonably reimbursed their costs of attending meetings.

5. Technical and Secretarial Support

All technical and secretarial support that is required by the Committee will be provided by the Institute.

6. Timing

A broad time table re. the work to be carried out by the Committee is to be agreed with the Committee.

7. Conclusion

The Institute believes that the recommendations of this Committee would serve as a very useful starting point to improve corporate governance in public companies and will consequently contribute in a significant manner to the overall development of the capital market in this country. Such a course of action would also be in keeping with the Institute's declared mission which reads as:

"To be the premier national body of Accountants committed to serving society by promoting and developing accountancy expertise towards resource management at the highest levels of integrity and competence."



Annexe 7.3

Contributors to the Committee

- 1) Aitken Spence Corporate Finance (Pvt) Ltd. (Ms. N Sivapragasam)
- 2) Alliance Finance Co. Ltd. (Mr. B D Viswasam, Director)
- 3) Asian Hotels Corporation Ltd. (Mr. S. R. Gunanathan)
- 4) Anil Dabera & Co. (Pvt) Ltd. (Mr. Anil Dabera)
- 5) Association of Stock Market Investors (Mr. S Sudarshan, (Chairman) and Dr. N I Wikramanayake (Consultant)
- 6) Central Finance Co. Ltd. (Mr. C Wijenaike)
- 7) Ceylon Tea Services Ltd. (Mr. Merrill J Fernando, Chairman)
- 8) Chartered Institute of Management Accountants, Sri Lanka Division (Mr. Upali Ratnayake, Director)
- 9) Coopers & Lybrand (Mr. P D Rodrigo)
- 10) Colmans Garment Industry (Pvt) Ltd. (Mr. A Hudah)
- 11) Commercial Bank of Ceylon Ltd. (R Samaranayake, Deputy General Manager)
- 12) Mr. Charitha P de Silva
- 13) HLB Edirisinghe & Co. (Mr. ATP Edirisinghe)
- 14) Institute of Bankers of Sri Lanka (Mr. H M R Ellepola, Vice Chairman)
- 15) Institute of Chartered Accountants of Sri Lanka (Mr. S Sockalingam, Technical Director)

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16) Institute of Chartered Secretaries and Administrators in Sri Lanka (Mr. H M Fernando, Chief Executive)

17) Kingsley Jayalath & Co. (Mr. K N Jayalath)

18) Kreston M N S & Co. (Mr. Eric Abeysiriwardane)

19) Lanka Ventures Ltd. (Mr. J M. Alles)

20) Lanka Ceramic Limited (Mr. Tissa Jayaweera)

21) Mr. J P Madanayake (Retired Bursar University of Colombo)

22) National Development Bank (Mrs. C D Iddamalgoda, Deputy General Manager)

23) Repro Grafic Tec (Mr. S Santhirasegaran)

24) Securities and Exchange Commission of Sri Lanka (Mr. Mahinda Ambahera, Manager Market Research)

25) Sri Krishna Corporation Ltd. (Mr. Hari Selvanathan)

26) T A Securities Lanka (Pvt) Ltd. (Mr. R M B Senanayake)

27) United Tractor & Equipment Ltd. (Mr. Asoka Sirimane, Executive Director Finance)

28) Distilleries Company of Sri Lanka Ltd. (Mr. Athula Perera)

29) Mercantile Investments Ltd. (Mr. Naveen Rajapakse)

30) Colombo Stock Exchange (Mrs. Surekha Sellahewa)

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