Corporate Governance Assessment On The Business Today Top Twenty Five 2013-2014

The assessment methodology that has been used since 2011, was continued by Suren Rajakarier to assess corporate governance of the Business Today TOP TWENTY FIVE. The aim is to further enhance good corporate governance practices in listed companies and to influence better transparency and accountability in public listed companies which will result in the growth of the capital market and set an example for others to follow. Good governance cannot be achieved through legislation only. It can be encouraged by recognising good practices and promoting qualitative corporate governance practices.

Background
"Good corporate governance is about 'intellectual honesty' and not just sticking to rules and regulations, capital flowed towards companies that practiced this type of good governance". – Mervyn King (Chairman: King Report)

It is important to understand why shareholder rights matter because shareholder protection encourages investment, the development of capital markets, and, ultimately, economic growth. The Business Today TOP TWENTY FIVE companies are the best of blue chips in the country and contribute significantly to economic growth.

The purpose of this analysis is to assess the extent to which the Business Today TOP TWENTY FIVE companies report the structures, strategies, policies and management systems they have in place for good governance, address environment and social issues, combat bribery and corruption. The assessment focuses on how companies report on their approach to corporate governance and the efforts they are making to prevent or address misuse of resources.

The Governance Framework Is There To Encourage Efficient Use Of

Resources And Equally To Require Accountability For The Stewardship Of Those Resources.

Good governance contributes to the stability and equality in society, and Adrian Cadbury captures this aspect as he was instrumental in drafting the Cadbury Code in The UK. Adrian Cadbury: "Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society."

There is no generally applicable global corporate governance model. Therefore, Sri Lankan companies work within the parameters set out by a local code, regulations and certain expectations of shareholders. Assessment of corporate governance is a subjective area and a subject where you cannot satisfy the needs of all stakeholders. However this assessment is performed with an aim to encourage better transparency, accountability, fairness and responsibility founded upon the concept of disclosure to improve trust and confidence of shareholders.

Experience has showed that having a good code of conduct and an admirable governance structure on paper is futile, if the leadership chose to ignore the spirit of governance. What is important is the right tone at the top encouraging good governance practices and a corporate culture that embraces qualitative principles.

How to raise the bar on Governance

Some of the key aspects of achieving good corporate governance levels are considered in the assessment as listed in a section below. However, this issue focusses on the benefits of a properly functioning robust audit committee and some of the characteristics that could improve the level of governance. To improve governance, such an audit committee should be independent and provide timely and focused oversight.

The key benefits of a properly functioning audit committee are:

– Increased emphasis on risk and control with greater focus on financial reporting.

– Demonstration of the board’s intention to exercise care in reviewing financial information.
– Better understanding and knowledge of the organisation’s finances by non-executive directors and insight into the organisation’s accounting and control systems;
– Directors appreciate and understand both the internal and external audit processes.
– Internal audit function gets a clear directive as to the board’s expectations of its scope and coverage in assisting management to give assurance to the board and strengthens the internal audit function by giving it greater independence.
– Improved communication between the board and the external auditor.
– It provides a forum for the chief financial officer or finance director to raise issues of concern and for the external auditor to assert independence in the event of a dispute with management.

As This Includes Assessing Managements’ Decisions Of Accounting Policies, Estimates And Disclosures, Evaluating Significant And Unusual Transactions, An Audit Committee Cannot Fulfill This Responsibility Without Being Financially Literate.

One of the key responsibilities of the audit committee is to oversee and ensure the quality and integrity of financial reporting. As this includes assessing the managements’ decisions of accounting policies, estimates and disclosures, evaluating significant and unusual transactions, an audit committee cannot fulfill this responsibility without being financially literate.

Financial literacy means not only understanding what the financial statements represents, but more importantly encompasses understanding the effect those judgmental areas of accounting can have on any set of financial statements, and how management judgments can be abused to manipulate financial statements.

In practice this means that to be financially literate, the audit committee members must know which accounting standards apply to the business they are overseeing, understand the basic requirements of these standards, analyse them in enough detail to be in tune with the intricacies of each accounting standard, and recognise the areas that are prone to manipulation by management, and then be familiar with how different types of manipulation will flow through into the figures included in the financial statements.

While financial literacy is an essential skill for audit committee members, it does not necessarily mean that all audit committee members must have accounting or related financial experience. In some circumstances, it may be necessary to consider the appointment of members to the audit committee that have particular skills in, for example, legal or other technical field, to help strengthen the committee. Every member should have experience in some area pertinent to the business.

Some of the other characteristics required to be a best practice audit committee typically include the following;
Independence
– The committee should comprise only non-executive directors, of whom the majority are independent and the chairperson should be an independent non-executive director who is not the chairperson of the board.
– Where applicable, the external auditor, the head of internal audit, the chief financial officer, the chief executive officer, the compliance officer and the risk officer should attend all meetings by invitation. They are not, however, members of the audit committee. If necessary the Chairperson of the board also may be invited.
– The committee's independence should allow it to challenge management decisions and evaluate corporate performance from a completely free and objective perspective.

Being of sufficient size
– The audit committee should be large and diverse enough to represent a balance of views and experience, yet small enough to operate efficiently.
– The members should be able to contribute the necessary time with all members attending the meetings, regularly.
– An audit committee should have a minimum of three members, excluding invitees and co-opted individuals.

Having an effective charter/Mandate
– An audit committee should have an effective formal charter, which is approved by the board. The charter should;
– Provide a clear understanding of the committee's roles and responsibilities, which can be referred to by the board, the internal and external auditors.
– Define the overall purpose and objectives of the committee as well as its size,

qualifications of members, frequency of meeting, reporting responsibilities and authority to undertake special investigations and/or the use of experts.
– Be reviewed on a regular basis to ensure that the committee objectives are being met, and should be sufficiently flexible to adjust to the changing needs of the business.
– Require the audit committee to report to the board after each meeting of the audit committee on its activities and critical issues, including compliance with its charter.

Having a competent chairperson who allocates adequate time
– The chairperson should meet, independently, with each of the key role-players prior to each meeting so as to inform him/herself more fully on all the relevant information and developments.
– These meetings would include the internal auditors, external auditors, and relevant members of management.
– The pre-meetings will mean that the audit committee meeting itself will be focused, relevant and efficient.
– The chairman may choose to have the other independent non-executive members of the audit committee join these pre-meetings, if necessary.

Principles and disclosures considered in this assessment include;

Segregation of the roles of Chairperson and CEO and non-executive role of Chairperson.
Criteria for non-executive directors (NED) and independence policies
The inclusion of an integrated report that focuses on economic, environmental and social impacts and 3rd party certification
Extent of disclosures about participation by the directors at meetings and any related procedures that improve governance practices.
Disclosure of a formal policy prohibiting dealing in its securities by directors, officers and other selected employees for a designated period and monitoring thereof.
The positioning of internal audit as a strategic function that conducts a risk-based internal audit.
Whether a definitive set of standards and practices is implemented based on a clearly articulated code of ethics and disclosure to its' adherence.
Committees of the board, reporting procedures, existence of written mandates or

charters for the committees and ways of evaluating them.
Disclosures made with regard to performance appraisal of the Board of Directors and CEO.
Composition of the audit committee with independent and non-executive directors and financial literacy of its members.
Role of the Company secretary- disclosure of the role and assistance provided to the Board. Importance of this role to act as a central source of guidance on matters of ethics and governance.
Disclosure of the process in place for related party transactions to avoid conflict of interest and to comply with requirements for the transactions and rationale for transactions.
Contents of the audit report.
Disclosure of the business model operated by the company along with a detailed risk management report which sets out risk mitigating strategies used by the company.
Aspects included in the GRI Reporting Framework in relation to information disclosed in respect of bribery and corruption and involvement in public policy-making.

Fully informed

– The audit committee must have access to any information that it needs.
– The audit committee must have the right to seek independent advice and the power to investigate any matter within the ambit of its authority.
– The audit committee should ensure that its members receive relevant information necessary for its role on a timely basis.
– The audit committee should ensure effective communication among all those involved with the audit committee process.

Working effectively with internal audit

– The internal audit function gets its authority from the board of directors, but reports directly to the audit committee. The audit committee must assess the skills and resources of the internal audit function, the scope of its activities and the effectiveness of its operations.
– A well run audit committee relies on an effective internal audit function, which reports to it at each meeting and also has unrestricted access to the chairperson of the audit committee.
– The audit committee approves the internal audit plan, ensuring these are no

gaps in the overall audit process.
– The audit committee uses internal audit to review the way management manages business risk, as well as how it protects and enhances shareholder value.
– The audit committee evaluates the performance of the internal audit function including having an external review/assessment, regularly.

Actively engaged in monitoring and evaluating the audit process
– The audit committee must satisfy itself as to the independence of the external auditor, as well as assess the performance of the external auditor.
– The audit committee's lines of communication and reporting should facilitate independence from management and encourage the external auditor to speak freely, regularly and confidentially with the audit committee. It is important that the audit committee discusses any audit differences with the external auditor.
– The audit committee must actively engage in the appointment, replacement or re-appointment of the external auditor together with monitoring and evaluating the audit process.
– The audit committee must actively ensure that it has a strong and candid relationship with the external auditor.
– The audit committee must determine the scope and fee of the external audit and ensure that the audit is comprehensive and not compromised for fees.

Working to a properly structured agenda and recording minutes
– A detailed agenda should be prepared for all meetings and distributed to participants in advance of the meeting.
– Any supporting documentation to be tabled at the meeting should also be distributed with the agenda, at least a week in advance of the meeting, to enable participants to consider the documentation before the meeting properly.
– The invitees should be limited to those that are familiar with or responsible for, the topics on the agenda.
– Members are responsible for ensuring that the audit committee minutes are a fair and accurate reflection of the meeting.
– The minutes of the meeting of the audit committee should be placed before the board at its meeting that follows that of the audit committee. This will ensure that the board will not only receive the report of the audit committee chairperson, but it will also have the opportunity to consider any other issues that may be

contained in the minutes that may warrant consideration in addition to matters highlighted by the audit committee chairperson.

Ensuring proper disclosure in the Annual Report

– Companies should in their annual report disclose whether or not the audit committee has a charter and, if so, whether or not the committee satisfied its responsibilities for the year in compliance with its charter and terms of reference.
– The audit committee must strive for complete and accurate financial and non-financial information disclosure that complies with all relevant financial reporting standards and all other relevant regulations governing disclosures and compliance.

Self-evaluation

Use a third-party to interview or self-evaluation of effectiveness of the committee and the board to get a candid assessment of how the audit committee is performing against set criteria, annually.

Assessment approach

Corporate governance assessment can be done in several stages. This exercise is limited to a desk-top compilation of corporate governance profiles of the companies in the Business Today TOP TWENTY FIVE. Companies are scored from 0-100 based on their disclosure of information important for investors and the general public, like, corporate governance policies, level of compliance with local regulations, management controls, performance and what they are doing to prevent corruption along with some of the best practices identified through research. In the scoring, 100 is most transparent, and zero is least transparent.

This assessment does not conclude that companies with better scores (based on disclosures) will make better results or vice-versa or in fact are better governed. Some of the issues in Sri Lanka, where companies do not focus on transparency may relate to;
– Concentration of ownership and presence of a controlling shareholder
– Directors are related parties to the controlling party to primarily protect the nominator
– Level of financial literacy of audit committee members.
– Inadequate capital market regulation and/or monitoring mechanism.
– No consequence for non-compliance.
– Independent directors and NEDs have undisclosed interests in the said entity.

Findings and Conclusions

The slow improvement in scores over the years is not due to a lack of awareness by the Companies but due to an impotent monitoring system over the listing requirements of companies. Lack of monitoring does not help in improving compliance above the minimal level of 'tick a box' approach. This year, 40 percent (56 percent in 2013) of companies in the above list are below the 60 percent level of compliance. Some of the common deficiencies continue to be; level of independence of Independent directors, financial literacy and composition of audit committee members, lack of a strong framework for related party transactions and avoidance of conflicts of interest, non-disclosure of a formal policy prohibiting dealing in securities by directors and officers, not fully recognising the role of a company secretary, the strategic importance of internal audit and board balance between executive and non-executive directors, non-disclosure of policy on bribery and corruption. However, improvements were noted in several companies this year.

Maybe if the SEC or CSE start rating all listed companies on the actual practice of Corporate Governance, and compel everyone to raise the bar on Governance, we will observe all companies achieving over 70 percent compliance under this methodology.

Corporate governance affects the development and functioning of capital markets. It appears that these TOP TWENTY FIVE companies seem to be having an ability to produce consistent results which also indicates that the Boards are able to drive higher quality of earnings. What is important is that, excluding the six banks, the other companies have a concentration of ownership, driving their performance. Though there is a belief that institutional investors would pay a premium for well governed companies, due to the concentration of ownership small investors may benefit by investing in these companies, in the long term.

This publication serves as a recognition of Corporates who demonstrate good governance and transparency in their disclosures and congratulations to the boards and managements of these companies for continuing to be outstanding in their sectors and helping our capital market to be recognised, at a global level.

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