CORPORATE GOVERNANCE AND THE CHANGING FUNCTION OF AUDITING IN THE CORPORATE LEGAL ENVIRONMENT OF SRI LANKA: ACHIEVING FUTURE RESILIENCE

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ABSTRACT

This paper explores the complex relationship between the evolving function of auditing and corporate governance mechanisms in the legal environment of Sri Lanka. It emphasizes the significance of corporate governance in ensuring adherence to ethical standards, transparency, and accountability. The study also analyses the impact of the regulatory environment on corporate governance in Sri Lanka, particularly the country's efforts to align its standards with global benchmarks. Furthermore, the paper examines the impact of auditing on investor confidence and financial reporting integrity. The audit committee plays a leading role in maintaining financial accountability and transparency which is crucial to good corporate governance. Hence, measures to maintain its independence and strengthen its integrity are extremely vital. This paper aims to analyze the responsiveness of Sri Lanka's legal framework governing corporate entities, focusing on recent reforms and their potential impact on audit practices and corporate governance. It also examines the structure of audit committees, auditors' roles, and ways to enhance committee efficiency and ethical standards through qualitative analysis. The paper highlights the mutually beneficial relationship between auditing and corporate governance in ensuring the long-term viability of corporate entities. It emphasizes the need for a flexible legal framework that supports proactive auditing and governance practices in response to evolving business conditions. By effectively managing these interrelated components, Sri Lankan corporate entities can navigate periods of uncertainty, establish stakeholder confidence, and ensure continued prosperity in a dynamic business landscape.

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1. INTRODUCTION

Corporate governance (CG) refers to the regulations and practices that guide the direction and management of companies, aiming to facilitate effective, entrepreneurial and responsible management for long-term success. CG encompasses the procedures and framework employed to oversee and administer the operations and activities of business entities, aimed at strengthening shareholder value and guaranteeing the financial stability of enterprises. This involves delineating power distribution and implementing measures to ensure accountability among shareholders, the board and management. The Cadbury Committee defines CG as the mechanism through which companies are directed and controlled. It is the foundation of organizational integrity and ethical standards. CG is a system that promotes cooperation and alignment between the owners and management of a company. Its goal is to prioritize the interests of shareholders and the company as a whole, which helps to prevent issues such as wastage, corruption and mismanagement. By ensuring that the company operates in the best interests of all shareholders, CG also supports brand building and growth. It defines the relationships between management, the board of directors, shareholders and other stakeholders, shaping decision-making, accountability and transparency within the company. Effective CG promotes trust and confidence, attracts investors and ensures sustainable growth'.[1]

'An audit is an independent examination of financial information of any entity, whether profit-oriented or not, irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon'.[2] 'The purpose of an audit is to provide assurance to stakeholders that the financial statements are free from material misstatement and are presented fairly in accordance with relevant accounting standards'.[3] Auditing is a crucial aspect of CG, particularly

1 FasterCapital, 'The Role of Auditors In Corporate Governance And Regulatory Compliance' (*FasterCapital*, 2023) https://fastercapital.com/topics/the-role-of-auditors-in-corporate-governance-and-regulatory-compliance.html accessed 1 August 2024.

2 Painless Audit, 'The Backbone of Trust in Business: Understanding Financial Statement Audits' (*Painless Audit*, 2023) https://www.painlessaudit.com/blog-posts/the-backbone-of-trust-in-business-understanding-financial-statement-audits accessed 2 August 2024.

3 Dolly Kumari, 'Commonly Asked Questions and Answers Related to Audit and

through internal auditing. It is a critical component of this system, as it 'provides an independent assessment of a company's financial statements and internal controls. Auditing involves systematic examination and evaluation conducted by impartial professionals, serves to verify the accuracy and reliability of financial information'.[4] This safeguards stakeholders' interests and contributes to the long-term success of businesses.

CG is primarily managed by the board of directors. It defines the roles and responsibilities of various stakeholders, including shareholders who appoint directors and auditors to ensure that proper governance standards are upheld. The board of directors is responsible for defining the organization's values and ensuring its strategic direction. Effective CG has numerous benefits, such as strengthening corporate success and economic advancement, maintaining investor confidence and facilitating efficient capital raising while reducing capital costs.

Internal auditors play a crucial role in organizations by providing an unbiased assessment and advisory function. Their main goal is to improve operational efficiency and risk management. They do this by evaluating and improving governance systems, advocating for necessary changes and providing objective assessments of governance structures and operational processes. Additionally, internal auditors offer advice on governance best practices to enhance transparency and accountability within the organization. They also help organizations navigate regulatory requirements and ensure compliance by assessing whether governance components align with industry standards. In recent years, internal auditing has expanded to include a focus on strategic, operational, financial and compliance risks. This allows them to provide the board of directors with objective and independent insights to guide decision-making and ensure organizational resilience.

Assurance' (*LinkedIn*, 11 April 2024) https://www.linkedin.com/pulse/commonly-asked-questions-answers-related-audit-assurance-dolly-kumari-otf3c/ accessed 7 August 2024.

[4] FasterCapital, 'Understanding Corporate Governance and Board Development' (*FasterCapital*, 2023) https://fastercapital.com/topics/understanding-corporate-governance-and-board-development.html accessed 7 August 2024.

2. THE RELATIONSHIP BETWEEN AUDITING AND CG

The relationship between auditing and CG is crucial for the long-term sustainability and success of businesses. 'Auditing is a key tool for verifying the accuracy and reliability of a company's financial information, ensuring compliance with accounting standards'.[5] Therefore, auditing serves as an essential component of CG. CG mechanisms, such as audit committees, oversee the auditing process to ensure independence and effectiveness. By establishing accountability frameworks and promoting ethical behavior, governance structures reinforce transparency and trust in corporate operations. Both auditing and CG are crucial in reducing risks and improving decision-making within organizations. Auditors assess financial risks, internal controls and regulatory compliance, identify areas of concern and suggest improvements to strengthen corporate resilience. CG frameworks create risk oversight mechanisms, promote effective decision-making processes and encourage prudent risk management, thereby supporting the long-term sustainability of corporate entities.

The relationship between auditing and CG boosts investor confidence and access to capital markets. Independent audit opinions provide credibility and assurance to investors, while governance practices such as transparent disclosure and ethical conduct, attract investment, lower capital costs and support sustainable growth by enhancing investor trust and confidence. Furthermore, auditing serves as a vital tool for detecting and preventing fraud, errors and irregularities within the organization. By conducting thorough examinations of financial records and transactions, auditors can uncover discrepancies and inconsistencies that may indicate fraudulent activities or errors'.[6] This proactive approach to fraud detection not only protects the organization's assets but also safeguards its reputation and

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[5] FasterCapital, 'Demystifying the Auditing Process: Insights from the Big Four' *(FasterCapital*) https://fastercapital.com/content/Demystifying-the-Auditing-Process--Insights-from-the-Big-Four.html accessed 7 August 2024.

[6] FasterCapital, 'The Role of Auditors in Issuing an Unqualified Opinion' (*Faster Capital*, 2023) https://fastercapital.com/topics/the-role-of-auditors-in-issuing-an-unqualified-opinion.html accessed 7 August 2024.; DataSnipper, 'From Planning to Reporting: Exploring the Phases of the Audit Process' (*Data Snipper*, 2023) https://www.datasnipper.com/resources/phases-of-the-audit-process accessed 7 August 2024.

credibility in the eyes of stakeholders.[7]

The close relationship between CG and audit is evident, as audit plays a vital role in ensuring financial transparency, accountability and integrity. A strong CG framework typically includes mechanisms to achieve these objectives. It provides independent assurance to stakeholders, such as shareholders, regulators and the public, that the company's financial reporting is reliable. Auditors also assess the effectiveness of internal controls and compliance with laws and regulations, which are important aspects of CG. Furthermore, CG principles often dictate the composition and responsibilities of the audit committee, a subcommittee of the board of directors. 'The audit committee oversees the financial reporting process, appoints external auditors and reviews the results of the audit, ensuring the integrity of the company's financial reporting'.[8]

3. STATEMENT OF PROBLEM

The economic collapse in Sri Lanka has had a profound impact on the corporate sector and private business entities. Corruption, favoritism, heavy debt reliance and widespread incompetence are prevalent, posing significant challenges to the corporate environment.[9] The absence of proper audits and CG has further exacerbated instability, jeopardizing economic recovery. As the economy sinks deeper, the role of CG and auditing becomes increasingly critical. This research aims to investigate the nexus between CG, auditing practices and the evolving corporate legal environment in Sri Lanka amidst the current crisis. It seeks to address how inadequate CG and auditing practices exacerbate economic challenges and hinder the resilience of the corporate sector. By analyzing the interplay

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7 M E Edge, P Sampaio and M I Choudhary, 'Towards a Proactive Fraud Management Framework for Financial Data Streams' (Third IEEE International Symposium on Dependable, Autonomic and Secure Computing, September 2007) https://doi.org/10.1109/dasc.2007.25 accessed 7 August 2024.

8 Jack Ridley, *Cutting Edge Internal Auditing* (Wiley 2012).

9 World Bank Group, *Enhancing Government Effectiveness and Transparency: The Fight Against Corruption, Global Report* (September 2020) https://documents1.worldbank.org/curated/en/235541600116631094/pdf/Enhancing-Government-Effectiveness-and-Transparency-The-Fight-Against-Corruption.pdf accessed 7 August 2024.

between governance mechanisms, auditing standards and legal frameworks, this study aims to identify strategies for achieving future resilience.

The central question guiding this research is: How can enhancing CG practices and evolving auditing functions contribute to mitigating the impact of economic collapse in the corporate sector in Sri Lanka? Through a comprehensive examination of CG frameworks, auditing methodologies and legal frameworks, this study aims to provide actionable insights for policymakers, regulators, corporate leaders and auditors to foster a more resilient corporate environment in Sri Lanka.

4. THE OBJECTIVES OF THE RESEARCH

The purpose of this research is to investigate the relationship between auditing and CG in Sri Lanka's business environment. The study will recognize the evolving roles of auditing and CG within the country's legal framework. CG plays a critical role in maintaining ethical standards, transparency and accountability in Sri Lankan corporate entities, making it essential for sustainable business practices. The research will analyze the impact of the regulatory environment on CG standards and how it aligns with global benchmarks. This analysis will provide insights into Sri Lanka's commitment to international best practices. The study will also examine how auditing practices affect investor confidence and financial reporting integrity. It will emphasize the critical role of audits in maintaining market trust.

Furthermore, the research focuses on internal audit, audit committees and their significance in ensuring financial accountability and transparency, thereby requiring precautions to protect their autonomy and ethical standards. The study examines the configuration of audit committees and suggests strategies to enhance their effectiveness and adherence to ethical principles, which are crucial for optimal governance. It highlights the mutually beneficial relationship between CG and auditing in ensuring the enduring sustainability of corporate entities in Sri Lanka. The study emphasizes the need for a comprehensive legal framework that can be adapted to changing business circumstances. It aims to provide practical knowledge to Sri Lankan corporate entities to navigate uncertainties, gain the trust of stakeholders and maintain success in a constantly evolving business environment.

The study uses qualitative research techniques to analyze scholarly articles and legislative frameworks to arrive at comprehensive conclusions. Through critical examination of recent legal reforms and their potential impact on audit practices and CG frameworks, this study addresses contemporary concerns in the Sri Lankan business environment.

5. LIMITATIONS OF THE RESEARCH

The research acknowledges that there may be other factors that can influence the corporate legal environment and future resilience. However, it confines its scope to CG and auditing to offer valuable contributions and actionable recommendations for enhancing CG practices and auditing standards in Sri Lanka. The study aims to provide comprehensive insights into the challenges, trends and strategies that can enhance the resilience of the corporate sector in the future. The decision to narrow down the scope of the research to CG and auditing was justified because it allows for a more focused examination of key issues such as the effectiveness of internal audit, audit committees, regulatory frameworks governing auditing practices, the impact of CG reforms on auditing standards and the evolving role of auditors in ensuring transparency, accountability and integrity in financial reporting.

6. THE IMPACT OF CG AND AUDIT FAILURES ON CORPORATE ENTITIES

6.1 Global Experience

In the new millennium, a series of CG scandals occurred globally, which were categorized as major accounting scandals. These scandals involved materially misrepresenting financial statements to conceal the true financial position of companies and deceive stakeholders. These scandals were primarily observed in developed nations such as the USA, UK, Germany, Italy and the Netherlands. These countries were pioneers in implementing International Accounting Standards (IAS), International Financial Reporting Standards (IFRS) and General Accepted Accounting Principles (GAAP).[10] These scandals happened despite globally renowned

[10] E Tsianaka and A Stavropoulos, 'International Accounting Standards in the Public Sector: A Comparative Study of Greece and European Countries' (2023) 13 Theoretical Economics Letters https://doi.org/10.4236/tel.2023.134047 accessed 7

audit firms utilizing sophisticated auditing techniques.

The collapse of Enron in 2001 and subsequent scandals like WorldCom prompted the enactment of the Sarbanes-Oxley Act (SOX) in 2002, which underscored the critical role of robust audit committees in curbing earnings manipulation and strengthening financial transparency. These committees are characterized by their size, independence, frequency of meetings and financial acumen. Enron's downfall was attributed to poor CG, marked by unethical accounting practices and executive conflicts of interest, leading to fraudulent financial reporting that deceived investors and regulators.

The U.S. government responded to such fraudulent activities by introducing the audit committee (AC) as a pivotal component of internal control mechanisms. This committee comprises three key attributes: independence, expertise and oversight. Independence is particularly crucial in shaping internal control procedures, while the reviews and expertise provided by the committee are essential for ensuring efficient operations. It is essential that each member of the AC has adequate knowledge and expertise in accounting, auditing and law. Additionally, there is a need to enhance 'measures of independence, expertise, integrity and objectivity within the AC to strengthen its effectiveness'.[11]

Despite the recognition of AC as a significant step toward strengthening internal controls, challenges persist in ensuring complete independence and expertise among committee members, as well as maintaining their integrity and objectivity in practice. Moreover, the effectiveness of AC may be affected by factors such as organizational culture, regulatory frameworks and evolving fraud schemes. This highlights the importance of continually evaluating and improving AC practices.

The Enron scandal was a major corporate debacle that occurred in 2001. Enron, once a successful and innovative company, collapsed due to fraudulent accounting practices, lax oversight and conflicts of interest. The company used unethical accounting practices to hide its true financial health and inflate its reported earnings. Enron also employed complex financial structures and off-balance-sheet entities to conceal debt and

August 2024.

[11] S Balagobei and G Keerthana, 'Audit Committee Characteristics and Earnings Management: Evidence from Listed Capital Goods and Consumer Services Companies in Sri Lanka' (2022) 17(1) *Journal of Management* 46-61.

manipulate its financial statements. The board of directors lacked independent members and failed to provide adequate oversight. Enron's corporate culture, characterized by aggressive risk-taking and excessive compensation, promoted an environment conducive to unethical behavior. The auditing failures were also significant, as the external auditor failed to identify and report the fraudulent practices.[12]

The 2002 bankruptcy of WorldCom, which was precipitated by nearly $4 billion in accounting irregularities, brought to light the repercussions of inadequate corporate supervision. The conviction of CEO Bernard Ebbers on charges of fraud and conspiracy served to emphasize the severity of governance failures. The persistence of such extensive fraud can be attributed to the lack of rigorous oversight measures, highlighting the critical importance of strong audit procedures and vigilant audit committees.

Satyam's 2009 scandal, in which the company's founder Ramalinga Raju, admitted to years of profit and revenue inflation. This scandal brought to light significant flaws in the company's governance and control systems. As a result of the subsequent acquisition by Tech Mahindra, the necessity for stringent oversight mechanisms to prevent such misconduct was highlighted.[13] The €14 billion accounting fraud that precipitated the 2003 collapse of Parmalat demonstrated the severe repercussions of negligent governance and insufficient auditing. The use of fabricated financial statements to conceal liabilities and inflate earnings demonstrates the critical importance of implementing sound audit procedures to identify and avert such deceit.[14]

As a consequence of aggressive accounting, high debt and opaque financial

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[12] A S A Samaraweeraa, P M C Thilakerathneb and C Pathirawasam, 'Impact of Failures: A Review in the Perspective of Sri Lankan Corporates' (2021) 3(04) International Journal of Research in Commerce and Management Studies http://dx.doi.org/10.38193/IJRCMS.2021.3401 accessed 7 August 2024.

[13] 'Scandal at Satyam: Truth, Lies and Corporate Governance' (2009) A Business Journal from the Wharton School of the University of Pennsylvania https://knowledge.wharton.upenn.edu/article/scandal-at-satyam-truth-lies-and-corporate-governance/ accessed 7 August 2024.

[14] E M Cambaza, 'The Parmalat Scandal: An Analysis of Financial Deception and Its Implications for Global Business' (2024) 7(01) Revista Relações Sociais https://periodicos.ufv.br/reves accessed 7 August 2024.

reporting, Carillion was forced into liquidation in 2018.[15] Similarly, in a €1.9 billion accounting scandal, Wirecard's demise in 2020 underscored the critical importance of efficient audit mechanisms.[16] Revenue inflation and profit fabrication were enabled by inadequate supervision and auditing deficiencies, highlighting the criticality of implementing strong audit procedures to protect the interests of investors. These incidents demonstrate the grave consequences of inadequate governance and risk management. Effective oversight and auditing could have reduced these dangers and possibly prevented the catastrophe.

The aforementioned bankruptcies reveal the consequences of weak corporate oversight and inadequate auditing. In each case, financial fraud and mismanagement were enabled by lax governance and insufficient checks on financial reporting. Even though there were robust regulatory frameworks and a professional accounting environment, these large companies faced liquidity and profitability challenges. These incidents highlighted weaknesses in monitoring mechanisms and CG structures and highlighted the importance of strong CG frameworks and effective audit practices in ensuring transparency, accountability and the long-term success of companies. Proper audits and vigilant AC serve as crucial safeguards against fraud and financial mismanagement, ultimately protecting investors and stakeholders' interests.

As explained earlier, the SOX aimed to enhance the accuracy and reliability of corporate financial reporting disclosures for publicly listed companies. The SOX placed significant emphasis on the role of AC in overseeing financial reporting and legislative audit requirements. This was done to safeguard investor interests. Similarly, in the UK, notable developments in the Combined Code emphasized the importance of strengthening financial reporting quality through effective governance. This included the establishment of independent audit committees.

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15 P Marshom, 'What Happened to Carillion?' (*Arlingclose*, 2023) https://www. arlingclose. com/insights/what-happened-with-carillion accessed 7 August 2024.

16 W Siddiqui, 'The Wirecard Scandal: Lessons in Accounting and Financial Vigilance' (*LinkedIn*, 2024) https://www.linkedin.com/pulse/wirecard-scandal-lessons-accounting-financial-wahaj-siddiqui-2pcof/ accessed 7 August 2024.

6.2 Sri Lankan Experience

A series of catastrophic corporate failures has cast a shadow over Sri Lanka's economic landscape. It all began with the collapse of the Pramuka Savings and Development Bank (PSDB) in October 2002, triggering a domino effect of financial turmoil. PSDB, a bank authorized by the Central Bank of Sri Lanka (CBSL) to accept deposits from the general public, failed due to weak internal auditing and lack of CG. Corruption, mismanagement, lack of supervision, conflicts of interest and a lack of business strategy contributed to its collapse.[17] A 2002 report by the Securities and Exchange Commission of Sri Lanka (SEC) and the Institute of Chartered Accountants of Sri Lanka (ICASL)[18] revealed that the non-performing loans ratio of the bank was as high as 80%. The directors failed to comply with their duties to ensure safe and sound management of the bank affairs.

The Golden Key Credit Card Company Limited (GKCCC) faced a downfall in 2008, which raised concerns about the stability and integrity of the corporate sector. The GKCCC was the controlling shareholder of Seylan Bank, and its poor financial management was attributed to its collapse. The board of directors used the money of Seylan Bank's depositors to cover liquidity issues, causing fear and withdrawals. If they had followed the required framework, this collapse could have been prevented. The closure of GKCCC was a significant event 'in the financial history of Sri Lanka as it had a deposit base of Rs. 26.5 billion from 9,054 depositors, making it one of the largest asset-based financial institutions in the country'.[19] The company attracted many customers by offering interest rates ranging from 16% to 35%, which helped it to expand its deposit base. However, the failure of GKCCC had a cascading effect and led to the

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17 A Abeysinghe, 'Pramuka Savings and Development Bank Crisis in Sri Lanka' < https://www.academia.edu/5655062/PRAMUKA_SAVINGS_AND_DEVELOPMENT_BANK_CRISIS_IN_SRI_LANKA > accessed 7 August 2024.

18 Securities and Exchange Commission of Sri Lanka and The Institute of Chartered Accountants of Sri Lanka, *Code of Best Practice on Corporate Governance* (2008) https://www.casrilanka.com/casl/images/stories/content/members/corporate_governance_code.pdf accessed 7 August 2024.

19 A S A Samaraweeraa, P M C Thilakerathneb and C Pathirawasam, 'Impact of Failures: A Review in the Perspective of Sri Lankan Corporates' (2021) 3 (04) International Journal of Research in Commerce and Management Studies http://dx.doi.org/10.38193/IJRCMS.2021.3401 accessed 7 August 2024.

collapse of many other companies within the Ceylinco Group, impacting numerous stakeholders associated with the conglomerate.

The failure of the GKCCC had a detrimental impact on Sri Lanka's economy. It caused a loss of public faith in financial institutions, especially private ones. CBSL had to work on mitigating this negative impact. Analysts believe that the collapse of GKCCC and other Ceylinco Group companies was due to excessive inter-company transactions, particularly unjustified lending arrangements.

Another local example of this is Seylan Bank PLC, a listed commercial bank, where depositors suffered substantial losses. The bank took on excessive lending exposures and signed unfavorable contracts to obtain or deliver services to Ceylinco companies. The collapse had devastating effects on thousands of savers and pensioners and the State intervened to help Seylan Bank. It feared that the collapse would undermine the entire banking system in Sri Lanka. The Government of Sri Lanka and the CBSL helped mitigate the situation and implemented necessary measures.[20]

The CG rules, which were supposed to deter unethical business practices, have been controversial in assessing whether they stringently demanded the demonstration of directors' duties. Directors of listed entities often fail to abide by CG principles, failing to ensure an effective system that secures information integrity, internal controls, business continuity and risk.

The failure of Pramuka bank caused a chain reaction of other failures, including 'Mercantile Credit Limited, Union Trust and Investment Ltd, House and Property Traders Ltd, Translanka Investments Ltd and Home Finance Ltd, Seylan bank crisis and a pyramid scheme system followed by fraudulent activity by the Sakvithi group'.[21] Corporate excesses by senior management also caused the collapse of several non-bank financial institutions such as Galadari Hotels (Lanka) Ltd., Vanik Incorporation Ltd.

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20 Central Bank of Sri Lanka, *Financial Sector Developments and System Stability, Central Bank of Sri Lanka Annual Report - 2009* https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/publications/annual_report/2009/en/12_Chapter_08.pdf accessed 7 August 2024.

21 A S A Samaraweeraa, P M C Thilakerathne and C Pathirawasam, 'Impact of Failures: A Review in the Perspective of Sri Lankan Corporates' (2021) 3 (04) International Journal of Research in Commerce and Management Studies http://dx.doi.org/10.38193/IJRCMS.2021.3401 accessed 7 August 2024.

and the Finance Company Plc. The failures extended beyond regulated entities, encompassing finance companies such as Lankaputhra Development Bank, Mercantile Credit Limited, Touchwood Investments PLC, Entrusted Securities PLC, Central Investments and Finance PLC, Standard Credit Finance Ltd, ETI Finance Company and Swarnamahal Financial Services PLC. These collapses have not only shaken investor confidence but also exposed systematic weaknesses in CG mechanisms.

The collapse of finance companies had a severe impact on public trust and confidence, almost like a "financial tsunami".[22] Although these failures did not result in a complete financial system collapse, they still had a significant negative impact due to the erosion of public confidence. Various factors led to these failures, including the misuse of power and resources, irregularities in fund management and lending, deficiencies in CG practices, insufficient internal controls and risk management, financial reporting irregularities and a lack of transparency. These failures highlight the importance of robust governance frameworks, stringent regulatory oversight and proactive measures to protect investor interests and ensure financial system stability.

The failures of certain corporate entities had far-reaching social implications and affected a diverse group of stakeholders in Sri Lankan society. Regulators, the banking and financial sector, the economy, government, depositors and the general public all experienced the consequences of these closures and failures. The loss of life savings was devastating and resulted in unimaginable distress among depositors. Many of these individuals were retirees who relied on these funds for various critical needs. The news of these corporate failures led to tragic outcomes, including suicides, heart attacks and strokes among affected individuals who were unable to bear the financial loss. The cancellation of licenses meant that depositors lost their hard-earned savings, which they had saved for essential purposes such as medical expenses, education for their children, property purchases and starting businesses. The social impact of these events was significant, highlighting the urgent need for robust regulatory measures to protect the interests of depositors and prevent such

[22] W Weerasooriya, *A Textbook of Commercial Law* (Postgraduate Institute of Management 2010).

crises from recurring in the future.

In response to these scandals, revisions were made to CG regulations governing listed companies in Sri Lanka, alongside the introduction of new codes of conduct, aimed at safeguarding investors and restoring public confidence. Emphasis was also placed on promoting good behavioral practices in CG for corporate and financial institutions to prevent recurrence of such incidents.

7. GLOBAL PRINCIPLES OF CORPORATE GOVERNANCE

In 2004, the Organization for Economic Cooperation and Development (OECD) published its 'Principles of Corporate Governance.' These principles aim to establish global standards for CG. The first principle focuses on protecting shareholders' rights and ensuring that companies generate returns on the shareholders' investment. The second principle emphasizes the equitable treatment of all shareholders, including minority shareholders, individuals and foreign shareholders. It also highlights the importance of providing redress for shareholders whose rights are violated or who are oppressed by the majority. The third principle recognizes the legal rights of stakeholders and promotes cooperation with them to create wealth, employment and sustainable enterprises. The fourth principle emphasizes the importance of disclosure and transparency. Companies should provide relevant and timely information about financial performance, management and ownership of the business. Lastly, the fifth principle highlights the role of the board of directors in setting the company's direction and monitoring management to ensure the achievement of objectives. The CG framework must establish board accountability to the company and its members.

The United Nations Global Compact is a voluntary initiative that encourages businesses worldwide to promote sustainable and socially responsible practices among businesses worldwide. It encourages companies to adopt policies prioritizing human rights, labor, environment and anti-corruption. This initiative urges companies to integrate these principles into their strategies and operations, thereby promoting a positive impact on the global economy that is both inclusive and sustainable.

The Sustainable Stock Exchanges (SSE) Initiative, created by the United Nations, provides an effective platform to encourage stock exchanges to promote sustainable investment and improve corporate transparency regarding environmental, social, and governance (ESG) issues. Through this initiative, stock exchanges are motivated to support companies in adopting sustainable practices and reporting on their ESG performance, fostering a more transparent and responsible investment environment.

The Corporate Governance Group of the International Finance Corporation (IFC), which is a part of the World Bank Group, is committed to improving corporate governance practices in developing countries and emerging markets. Their focus is on providing advisory services, training programs, and other resources to assist businesses in these regions. The ultimate goal is to promote strong and effective corporate governance frameworks.

The International Standards Organization (ISO) 37000:2021 standard is designed to offer comprehensive guidance for organizational governance. It emphasizes key principles including accountability, transparency, ethical behavior, and sustainability, aiming to enhance the overall governance framework and practices within organizations.

The global initiatives mentioned above are crucial for setting standards, providing guidelines, and encouraging best practices in CG worldwide. They play a critical role in ensuring that companies operate ethically, transparently and in a way that promotes long-term sustainability and stakeholder value. This research will assess how CG standards in Sri Lanka align with these global initiatives.

8. THE ROLE OF CG AND AUDITING IN SRI LANKA'S BUSINESS ENVIRONMENT

CG and auditing are pivotal for fostering resilience and sustainability in a country's business environment. Transparent governance structures build trust among stakeholders and boost investor confidence, enhancing stakeholder relations amid evolving business practices. Strong governance frameworks enable companies to identify and mitigate risks, enhancing resilience against regulatory changes and economic fluctuations. Moreover, well-governed business entities tend to perform better over the long term, driving efficiency, innovation and competitiveness through aligned interests between management and shareholders. Effective CG also facilitates engagement with diverse stakeholders, promoting collaboration. Auditing ensures the accuracy and reliability of financial information, strengthening investor confidence and compliance with regulations.[23] Additionally, auditors play a critical role in detecting and preventing fraudulent activities, particularly amid heightened risks associated with corruption and financial irregularities. Through auditing processes, weaknesses in internal controls are identified and addressed, contributing to operational efficiency and risk management, thereby fostering long-term sustainability.

The evolving functions of auditing and CG in Sri Lanka are influenced by regulatory frameworks, market dynamics and socio-economic trends. The regulatory bodies in Sri Lanka have established auditing standards and CG, evolving in response to changes in accounting practices, emerging risks and international best practices. CG mechanisms, notably audit committees, oversee the auditing process, appoint auditors, review findings and ensure compliance with standards, thus reinforcing the effectiveness of both auditing and governance. Moreover, auditing contributes to transparency by providing assurance on financial information accuracy, complementing CG's promotion of transparency through disclosure requirements and accountability structures. In risk management, auditors assess financial risks and compliance, while governance establishes oversight mechanisms, vital for resilience and sustainability in Sri Lanka's diverse business environment.

CG serves as a cornerstone for upholding ethical standards, transparency and accountability within corporate entities. Ethical standards are upheld through governance frameworks that establish a culture of integrity, fairness and responsibility, promoting ethical decision-making across all levels of the organization. Transparent disclosure practices mandated by CG promote openness and facilitate informed decision-making among stakeholders. Stakeholder engagement is encouraged, promoting trust and long-term relationships. Boards of directors ensure transparency by scrutinizing management decisions and financial reporting processes,

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[23] FasterCapital, 'SEC Form 18: The Role of Auditors in Ensuring Accuracy and Reliability' (*FasterCapital*, 2023) https://fastercapital.com/content/SEC-Form-18--The-Role-of-Auditors-in-Ensuring-Accuracy-and-Reliability.html accessed 7 August 2024.

enhancing credibility. Accountability is reinforced through clear delineation of roles and responsibilities, performance evaluations and remedial measures in cases of poor performance or ethical misconduct. Overall, CG strengthens trust, mitigates risks and contributes to sustainability and success of corporate entities.

9. THE ESSENTIALS OF A LEGAL ENVIRONMENT FOR PROACTIVE AUDITING AND GOVERNANCE

Establishing a comprehensive legal structure that can adapt to changing business conditions is paramount for establishing the foundation for proactive auditing and governance procedures. In today's rapidly evolving business environment, laws and regulations need to be flexible and responsive to keep up with technological advancements, globalization and market disruptions. A comprehensive legal structure facilitates timely updates and amendments to regulations, enabling businesses to align with emerging trends, risks and opportunities. This adaptability ensures that regulatory frameworks remain relevant and effective in addressing evolving needs of auditing and governance practices, promoting economic dynamism and supporting sustainable growth.

Clear and up-to-date legal structures provide clarity in regulations, reducing ambiguity and uncertainty for businesses. By transparently outlining rights, responsibilities and obligations, a comprehensive legal framework simplifies the compliance process and minimizes the risk of non-compliance and associated penalties. This promotes a culture of adherence to governance standards and fosters transparency, accountability and ethical conduct. A legal framework that evolves alongside business dynamics empowers businesses to navigate complexities, seize opportunities and uphold integrity in their operations, reinforcing stakeholder trust and contributing to long-term sustainability in the corporate environment.

Further, effective CG relies on a solid legal foundation that defines the rights, duties and accountability of directors, executives and shareholders. A comprehensive legal structure establishes governance principles, standards and mechanisms for promoting transparency, accountability and ethical conduct. Proactive governance procedures, guided by clear legal mandates, empower boards of directors, AC and other governance bodies to oversee organizational performance, manage risks and protect stakeholder interests. Governance mechanisms supported by robust legal frameworks enhance organizational resilience and long-term viability. Transparency, fairness and consistency in the legal system build trust and confidence among stakeholders, including investors, customers, employees and the public.

Predictable legal frameworks signal stability, reliability and adherence to the rule of law, promoting a conducive business environment. Proactive auditing and governance procedures, underpinned by a trusted legal framework, reinforce organizational integrity, credibility and reputation. Stakeholders have confidence that businesses operate ethically, comply with regulations and are accountable for their actions, leading to enhanced trust and sustained relationships.

10. THE RESPONSIVENESS OF THE LEGAL FRAMEWORK GOVERNING CORPORATE ENTITIES IN SRI LANKA

This section evaluates how effectively Sri Lanka's legal framework governing corporate entities responds to changes in the business environment, market dynamics and global best practices. The *Companies Act*, no.7of 2007 is the foundation of Sri Lanka's legislative framework, governing the establishment, operation and dissolution of companies. The amendments in 2007 to the company law in Sri Lanka made in response to emerging issues and to align with international standards. The Securities and Exchange Commission law regulates capital markets and is revised to enhance regulatory oversight and adapt to evolving market conditions.

The Regulatory Environment on CG in Sri Lanka encompasses a range of laws, regulations, codes and guidelines established by entities such as the Securities and Exchange Commission of Sri Lanka (SEC), the Colombo Stock Exchange (CSE) and the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka).[24] Key regulatory instruments, including the *Companies Act*, Listing Rules, CG Code and accounting standards, set requirements on CG practices, in areas such as board composition, independence, disclosure, transparency, shareholder rights and audit and

[24] 'SEC, CSE and CA Sri Lanka Sign MoU to Encourage Non - Financial Reporting' Daily Mirror (Sri Lanka, 2 September 2022) https://www.dailymirror.lk/print/business-news/SEC-CSE-and-CA-Sri-Lanka-sign-MoU-to-encourage-non-financial-reporting/273-244160 accessed 7 August 2024.

risk management. Efforts to enhance board independence, for instance, aim to strengthen oversight and decision-making processes, aligning with global best practices. Mandatory disclosure requirements for financial information and CG practices promote transparency, instill investor confidence and align Sri Lanka's standards with global transparency benchmarks. Similarly, measures to protect shareholder rights ensure compliance with international accounting standards and strengthen regulatory oversight of auditing and risk management practices strengthen the reliability of financial reporting and internal controls within Sri Lankan companies.

Moreover, Sri Lanka has undertaken various initiatives to align its CG standards with global benchmarks, including revisions to codes, adoption of international accounting standards and capacity-building programs for directors and auditors. Collaboration with international organizations and regulatory bodies facilitates knowledge-sharing and technical assistance, highlighting Sri Lanka's commitment to aligning with global standards. However, challenges such as capacity constraints and enforcement issues persist, necessitating ongoing regulatory reforms, capacity-building initiatives and awareness programs to address them effectively.

11. COMPLIANCE WITH CG

The existing CG regulations for Sri Lankan listed companies comprise of mandatory and voluntary provisions. Mandatory requirements include establishing audit and remuneration committees with independent non-executive directors. These requirements aim to enhance financial reporting quality, credibility and transparency in determining director compensation. The ICASL Code of Best Practice provides voluntary provisions.

In Sri Lanka, following global initiatives, the ICASL has been actively involved in formulating and publishing codes of best practices related to CG and financial aspects. In December 1997, the ICASL published the Code of Best Practice on financial aspects of CG, followed by the Code of Best Practice on Audit Committees in May 2002 and the Code of Best Practice on Corporate Governance in March 2003.[25] These updates were

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[25] H Dissanayake, H Dissabandara and R Ajward, 'An Evaluation of the Compliance of Sri Lankan Listed Companies with Corporate Governance Principles and Best Practices' (*ResearchGate* 1 March 2022) https://www.researchgate.net/publication/359756368_An_Evaluation_of_the_Compliance_of_Sri_Lankan_Listed_Companie

aligned with the UK Combined Code on CG. In 2005, the Securities and Exchange Commission of Sri Lanka (SEC) and ICASL updated the corporate governance framework for companies in Sri Lanka, drawing from the New York Code and other developed jurisdictions.[26] The rules on CG were once again revised by the SEC and ICASL for listed companies, which were implemented on 1st April 2007 and became mandatory for listed companies from 1st April 2008. The Revised Code of Best Practice on CG was developed in 2013 to address changing requirements in the business landscape.

In 2017, the CA Sri Lanka revised its Code of Best Practice on CG to include principles related to environment, sustainability and governance (ESG), as well as provisions pertaining to the Internet of Things (IoT). This ongoing refinement demonstrates a commitment to adapting to emerging trends and ensuring relevance in contemporary business practices. Sri Lankan listed companies are required to follow mandatory CG regulations as outlined in the CSE Listing Rules. However, these rules only establish basic standards, leaving gaps that are addressed by the ICASL Code of Best Practice 2008. The Companies Act No. 07 of 2007 and the Central Bank Direction on CG also contain certain provisions related to director and auditor appointments. Even though the Listing Rules do not mandate it, both the ICASL Code and the CBSL Direction advocate for the separation of the chairman and CEO roles, due to the distinct nature of activities of each role.[27] This separation aims to balance power, enhance accountability and foster independent decision-making within the board structure.

‘Influenced by the British corporate model, Sri Lankan companies typically adopt a unitary board structure, similar to that of the UK, US, Australia and South Africa, comprising both executive and non-executive directors. While executive directors engage in day-to-day management, non-executive directors offer an impartial perspective due to their detachment from management duties. The Listing Rules require a mix of

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s_with_Corporate_Governance_Principles_and_Best_Practices accessed 7 August 2024.

[26] H Cabraal, *Duties of Company Directors & Corporate Governance in Sri Lanka* (Updated 2nd edn, 2019).

[27] Contrary to this, Marks & Spencer, a prominent company in the UK, once had a time when one individual simultaneously held both roles.

executive and non-executive directors on the board, including at least two non-executive directors or one-third of total directors, whichever is higher. Additionally, these directors must be independent from management and free from any conflicting relationships'.[28]

The *Companies Act*, CBSL Directions and ICASL Code outline directors' duties, which include financial reporting, internal control maintenance, risk management and operational conduct. Board committees, mainly composed of non-executive directors, are responsible for overseeing potential conflicts of interest between shareholders and managers. Companies are required to establish audit and remuneration committees to supervise executive compensation, financial reporting, internal controls and risk management, as per the Listing Rules.[29] The ICASL Code also mandates a nomination committee for director selection. Commercial banks licensed by the CBSL Direction must appoint all three committees in addition to an integrated risk management committee.

CG is a crucial aspect of any company, and external auditors play a significant role in providing an impartial assessment of financial statement accuracy. In Sri Lanka, the Companies Act 2007 mandates shareholders to appoint external auditors at the AGM. Additionally, both Listing Rules and CBSL Direction require interaction between the board and external auditors through the AC. It is also suggested in the ICASL Code and CBSL Direction to appoint an internal auditor reporting directly to the AC to preserve independence.

Despite the widespread presence of audit committees in Sri Lankan companies, there is a lack of transparency in the determination of directors' remuneration. This may be attributed to the dominance of accounting professionals on board. However, there is a concern about the absence of a mandatory nomination committee for board appointments, except for licensed commercial banks.[30] Transparent board appointments are crucial

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[28] K K Nazliben, L Renneboog and E Uduwalage, 'Corporate Governance from Colonial Ceylon to Post-Civil War Sri Lanka' (2023) Journal of Management and Governance https://doi.org/10.1007/s10997-023-09678-5 accessed 7 August 2024.

[29] A M Masli, 'The Role of the Audit Committee as a Corporate Governance Mechanism: The Case of the Banking Sector in Libya' (PhD thesis, Nottingham Trent University 2018) https://core.ac.uk/download/pdf/161816027.pdf accessed 7 August 2024.

[30] The G20/OECD principles recommend establishing a Nomination Committee to ensure compliance with nomination procedures and to assist in identifying a well-

for effective governance, yet many Sri Lankan companies seem to lack transparency in this area.

The Listing Rules fall short in emphasizing the establishment of internal control systems, including risk management and internal audit functions, which are integral to effective governance. This oversight may undermine the audit committee's authority in overseeing internal controls. Conversely, licensed commercial banks, under the Central Bank Direction, prioritize enhancing risk management and internal controls. Despite permitting parent company committees to oversee subsidiary activities, practical challenges may arise for parent companies with numerous subsidiaries, casting doubt on the feasibility of this provision.

The *Securities and Exchange Commission Act* No. 19 of 2021 (SEC Act 2021) replaced the 1987 Act and aims to improve CG and transparency in publicly listed companies. It mandates the submission of annual reports, including CG policies, within five months of the balance sheet date. The SEC Act 2021 emphasizes the importance of timely financial disclosures to uphold best CG practices, enhance investor confidence, and preserve market integrity. Under the SEC Act 2021, the Commission or market institutions can request information from listed companies, enforce compliance, and compel directors and CEOs to adhere to regulations. Auditors, market institutions, and intermediaries are required to report any irregularities, thus strengthening CG and reducing systemic risks in the securities market. The SEC Act 2021 aims to increase transparency and accountability in the corporate sector by aligning with evolving CG standards. This is intended to enhance investor confidence and reduce the risk of non-compliance. The Act holds directors, CEOs, auditors, and market participants responsible, ensuring that business operations run smoothly and reinforcing investor trust. The SEC Act 2021 brings in significant reforms to enhance CG and transparency in listed companies by requiring timely reporting and improving enforcement mechanisms. While these measures are in line with global CG standards and are designed to enhance investor confidence, challenges remain in ensuring effective implementation and enforcement.

The *Companies Act* No. 7 of 2007 of Sri Lanka (2007 Act) is the primary legislation governing corporate entities in Sri Lanka and includes

balanced and qualified Board.

provisions that encourage CG practices. It was introduced to modernize CG structures and address shortcomings in previous law, the *Companies Act* No. 17 of 1982 (1982 Act), which hindered corporate growth. The 2007 Act establishes the core duties of directors, requiring them to act in the company's best interests, refrain from actions that violate the Act or the company's articles, avoid conflicts of interest and exercise reasonable care and skill.[31] The 2007 Act also imposes obligations on directors to address capital losses and instances of insolvency promptly, with potential personal liability for any losses incurred by creditors.[32] Directors are also required to disclose transactions with the company in which they have a personal interest, although they can still participate in decisions and meetings related to these transactions.[33] The Act mandates the disclosure of directors' remuneration, but it does not specify individual amounts, hindering transparency. However, the enforcement of these provisions has been lacking, allowing instances of deliberate mismanagement and fiduciary misconduct to persist, undermining the effectiveness of the company law regime.

Overall, Sri Lanka's CG framework incorporates essential elements, such as audit committees and independent director appointments. However, addressing gaps in transparency, internal control systems and subsidiary governance is necessary for future reforms.

12. UNDERSTANDING AUDITING: PRINCIPLES AND SIGNIFICANCE

Auditing involves a systematic and independent examination of an organization's data, statements, records, operations and performances,[34] whether financial or otherwise, for a specific purpose. The acronym AUDITOR encapsulates this process: Audit is an independent and

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31 Sections 187, 188, 189, 191 and 192 of 2007 Act.

32 Sections 219 and 220 of 2007 Act.

33 Sections 192 and 196 of 2007 Act.

34 TutorialsPoint, 'Auditing – Introduction' (*TutorialsPoint*, 2023) https://www.tutorials point. com/auditing/auditing_introduction.htm accessed 7 August 2024. See also India Briefing, 'An Introduction to Audit in India for Non-Auditors' (*India Briefing*, 29 May 2013) https://www.india-briefing.com/news/introduction-audit-india-nonauditors-6416.html/ accessed 7 August 2024.

systematic examination of accounting and other Underlying Data and Information to provide an Opinion in the audit Report'.[35] This definition highlights several key aspects of auditing. Firstly, audits are conducted systematically and independently by qualified professionals, such as chartered accountants for financial audits. Secondly, audits are not limited to financial matters and may extend to areas like management. Thirdly, 'audits are conducted with a stated purpose, such as verifying the accuracy of financial statements'.[36] Fourthly, the focus of audits may vary depending on the assignment, from ensuring a true and fair view to assessing cost-effectiveness. Fifthly, audits rely on evidence, regardless of the nature of the propositions being reviewed. Finally, audit findings are communicated to the appointing authority, such as shareholders in the case of a company.

'Moreover, auditing ensures compliance with legal and regulatory requirements, helping companies navigate the complex landscape of laws and regulations governing financial reporting and disclosure'.[37] By conducting audits in accordance with established standards and regulations, companies can mitigate the risk of legal and regulatory sanctions, thereby enhancing their resilience and sustainability in the face of regulatory scrutiny. 'Finally, auditing provides assurance to stakeholders regarding the organization's financial health and performance. By offering an independent and objective evaluation of the company's financial statements and internal controls, auditors instill confidence among investors, creditors and other stakeholders, fostering trust and credibility in the organization'.[38] In essence, the multifaceted objectives of auditing in CG underscore its critical role in ensuring accountability, transparency and integrity within organizations, ultimately

[35] India Briefing, 'An Introduction to Audit in India for Non-Auditors' (*India Briefing,* 29 May 2013) https://www.india-briefing.com/news/introduction-audit-india-nonauditors-6416.html/ accessed 7 August 2024.

[36] TutorialsPoint, 'Auditing - Introduction' (*TutorialsPoint*, 2023) https://www.tutorials point. com/auditing/auditing_introduction.htm accessed 7 August 2024.

[37] FasterCapital, 'The Role of Auditors in Enhancing Internal Control Effectiveness' (*FasterCapital,* 2023) https://fastercapital.com/topics/the-role-of-auditors-in-enhancing-internal-control-effectiveness.html accessed 7 August 2024.

[38] FasterCapital, 'Examining Auditing and Assurance Services: The Importance of Auditor Opinions for Investors and Stakeholders' (*FasterCapital,* 2023) https://fastercapital.com/topics/examining-auditing-and-assurance-services.html accessed 7 August 2024.

contributing to their long-term success and sustainability.

‘Auditing serves as a cornerstone in upholding the reliability and trustworthiness of financial data, offering a multitude of advantages to organizations. Firstly, it elevates the quality of financial reporting by enhancing the precision and dependability of financial statements, thereby promoting confidence among stakeholders such as investors, creditors and others. Secondly, auditors possess the expertise to uncover potential instances of fraud, errors and irregularities, thereby mitigating financial losses and preserving the organization's reputation. ‘Thirdly, auditing evaluates the effectiveness of internal controls and risk management systems, providing valuable insights for enhancing operational efficiency and minimizing risks’.[39] Additionally, it safeguards the interests of stakeholders by ensuring ethical operations, adherence to legal and regulatory requirements and alignment with stakeholders' best interests. Moreover, reliable financial information obtained through auditing empowers management to make informed decisions, facilitating effective resource allocation and strategic planning. Lastly, auditing helps organizations in maintaining compliance with legal and regulatory standards, ensuring adherence to accounting principles, tax regulations and industry-specific guidelines. The audit process significantly enhances investor confidence and maintains the credibility of financial reporting as a necessary assurance mechanism in the corporate world. Auditors conduct an independent examination to ensure the accuracy and reliability of financial statements, ensuring they present a genuine and impartial view of a company's financial status, performance and cash flows. This scrutiny helps maintain the transparency and integrity of financial information, signaling financial health vital for investors, lenders and other stakeholders who rely on such data to make informed decisions.

Moreover, auditing enhances investor confidence by providing assurance in the credibility and reliability of financial information disclosed by companies. Independent scrutiny by qualified auditors reduces information asymmetry, signaling financial health and management credibility of the company to investors. Audit opinions, whether positive or negative, serve as indicators of financial strength, enabling investors to make informed decisions and assess risks. Ultimately, audit opinions empower investors to evaluate a company's financial healthiness and make the right

[39] ibid.

investment decisions.

Furthermore, auditing helps to reduce the imbalance of information between company insiders and external stakeholders, thereby playing a key role in promoting market efficiency and liquidity. By providing an independent assessment of a company's financial performance and internal controls, auditors can bridge knowledge gaps and mitigate the potential for manipulation of financial information.[40] This ensures a level playing field for investors and encourages market participation, leading to increased market activity and capital allocation to productive investments. It is evident that auditing is a crucial element in safeguarding the integrity of financial markets.

Additionally, auditing safeguards the interests of stakeholders by verifying compliance with accounting standards, regulatory requirements and contractual obligations. The independence and objectivity of auditors ensure that stakeholders can rely on audit opinions to evaluate the sustainability of the business. This, in turn, protects them from financial fraud, mismanagement and non-compliance risks. This assurance extends beyond investors to creditors, suppliers, employees and regulatory authorities, enhancing trust and facilitating informed decision-making across the corporate ecosystem.

13. SRI LANKAN LAW ON AUDITORS

The 2007 Act provides clear guidelines for the appointment and disqualification of eligible individuals to serve as auditors for companies. As per the 2007 Act,[41] an auditor should have professional qualifications and must either be members of the Institute of Chartered Accountants of Sri Lanka or registered auditors.[42] According to Section 157(2), individuals cannot serve as auditors for companies, except for private companies or companies limited by guarantee, unless they are members of

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[40] FasterCapital, 'Examining Auditing and Assurance Services: The Importance of Auditor Opinions for Investors and Stakeholders' (*FasterCapital,* 2023) https://fastercapital.com/topics/examining-auditing-and-assurance-services.html accessed 7 August 2024.

[41] All statutory provisions referenced in this part of the paper are from the Companies Act No. 7 of 2007 (2007 Act)

[42] Section 157(1).

the Institute of Chartered Accountants of Sri Lanka. The 2007 Act sets out the rules regarding who can be appointed or act as an auditor for companies. The following individuals are disqualified from acting as auditors: a) directors or employees of the company, b) individuals who are partners or employed by a director or employee of the company, c) liquidators, administrators, or receivers handling the company's assets, d) a body corporate and e) individuals who have been disqualified from auditing related companies under (a), (b), or (c).[43]

Furthermore, individuals who previously held positions as directors, employees, partners or liquidators for a company cannot be appointed or act as auditors for a period of two years after leaving that position.[44] In addition, Section 527 gives the Minister the power to establish regulations regarding various matters, including the qualifications required for registered auditors, the registration process and the associated fees.[45]

The Act sets out for the automatic re-appointment of auditors for companies, except for the first auditor of a newly incorporated company. An auditor appointed by the board is automatically re-appointed at the annual general meeting, unless certain conditions are met.[46] These conditions include the auditor being unqualified for re-appointment, the company passing a resolution appointing a replacement auditor or the auditor notifying the company of their unwillingness to be re-appointed.[47] However, automatic re-appointment does not occur if the proposed replacement auditor dies, becomes incapable or is disqualified.[48]

In terms of the first auditor's appointment, Section 159(1) allows the board to appoint the initial auditor before the first annual general meeting, with their term ending at the conclusion of that meeting. If the board fails to do so, Section 159(2) mandates the company to appoint the first auditor at a meeting of the company. It is noteworthy that Section 159(3) specifies that neither the board nor the company is required to appoint an auditor if a

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[43] Section 157(3).

[44] Section 157(4).

[45] Section157(5).

[46] Section 159(1).

[47] Section 158(1).

[48] Section 158(2).

unanimous shareholder resolution is passed by the shareholders against appointing an auditor and such resolution ceases to be effective at the start of the first annual general meeting. Additionally, Section 158(1) ensures that a qualified auditor is automatically re-appointed after an annual general meeting. However, Section 160(1) prohibits a company from appointing a new auditor without providing the current auditor with at least twenty working days' notice and an opportunity to make representations to shareholders. These representations may be made in writing or orally at a shareholders' meeting, as chosen by the auditor or their representative. Section 160(2) entitles auditors to making representations to reasonable fees and expenses from the company.

Auditors of companies can resign or cease to hold office for any reason and if they resign or stop holding office, the Act requires auditors to provide a statement detailing the circumstances related to their resignation or ceasing to hold office to the company within ten working days of ceasing office.[49] This statement must detail any relevant circumstances they believe should be brought to the attention of shareholders or creditors or if they consider that there are no such circumstances, a statement affirming that there are none.[50] The statement must be submitted along with their resignation notice or if the auditor does not wish to be re-appointed or if the auditor ceases to hold office for any other reason. Failure to do so is considered an offence under the Act.[51]

If the auditor includes circumstances requiring attention, the company must distribute the statement to shareholders and submit a copy to the Registrar.[52] This is a mandatory obligation, unless permission from the court is obtained.[53] If permission is not obtained, the company and officers in default will be guilty of an offense.[54] The auditor must bear the court application costs. This provision makes it difficult for a company to dismiss its auditor, except for clear incompetence, impropriety, or legitimate reasons like a take-over by another company. Similarly, auditors

[49] Section 161(2).

[50] Section 161(1).

[51] Section161(4).

[52] Section 161(3).

[53] Proviso to Section 161(3).

[54] Section 161(5).

cannot quietly resign to evade exposing scandals of which they had knowledge.

Auditors have certain obligations as per the law. These include auditing a company's financial statements and preparing a report for shareholders.[55] To do this, auditors have the right to access the company's accounting records and other documents at all times.[56] If the company's board fails to provide access, the defaulting directors can be held liable.[57] This right cannot be overridden by any provision in the company's articles of association, as stated in Section 13, which prohibits inconsistency with the Act. The case of *Newton v Birmingham Small Arms Co*[58] affirmed the importance of auditors having unfettered access to necessary information.

Auditors are also entitled to demand information and explanations from directors or employees of the company to perform their duties effectively.[59] If access is denied or false information is provided, it constitutes an offense.[60] However, employees can defend themselves by demonstrating either the lack of required information or their inability to provide explanations due to their position or assigned duties.[61] These provisions are essential in ensuring transparency and accuracy in financial reporting. They underline the crucial role of auditors and the corresponding legal framework that supports their access to relevant information.

As per the Act, it is not only the right of auditors but also the duty of company boards to ensure that auditors have certain privileges with respect to shareholders' meetings. These privileges include allowing auditors to (a) attend all shareholder meetings and (b) receive the same notices and communications as shareholders regarding these meetings.[62] Further, auditors have the statutory right to speak on any matter concerning them

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[55] Section 163(1) and Section168(1)(c).

[56] Section 164(1).

[57] Section 164(3).

[58] (1906) 2 Ch 378.

[59] Section 164(2).

[60] Section 164(4).

[61] Section 164(5).

[62] Sections165(1) (a) and (b).

as auditors during shareholder meetings.[63] If the board fails to uphold these rights, every defaulting director will be deemed guilty of an offence.[64] These provisions highlight the importance of auditors' participation in shareholder meetings to ensure transparency and accountability in CG. Additionally, they empower auditors to fulfill their responsibilities and provide valuable insights to shareholders regarding the company's financial affairs. Acquiring comprehension of both accounting practices and internal control mechanisms is crucial for auditors. It helps them evaluate the reliability of the information gathered during the audit process. However, practical application of this approach can be challenging due to complexities in modern accounting systems and complex internal control structures. It may also depend on the auditor's expertise and the quality of information provided by the enterprise.

The Act outlines the statutory duties of auditors, which include auditing the company's financial statements and if necessary, group financial statements, as mandated by Section 154(1)(b). Additionally, auditors must prepare a report for the company's shareholders based on the audited financial statements.[65] This report becomes part of the company's annual report distributed to shareholders, in compliance with Section 168(1)(c). The statutory requirements for the auditor's report include specifying the basis of opinion, the scope and limitations of the audit, confirmation of obtaining necessary information and explanations, assessment of proper maintenance of accounting records by the company, determination of whether the financial statements provide a true and fair view and verification of compliance with relevant statutory requirements.[66] These provisions highlight the critical role of auditors in ensuring transparency and accuracy in financial reporting, as well as their obligation to provide shareholders with reliable information regarding the company's financial affairs.

The law requires auditors to be impartial and free from any relationship or interest in the company or its subsidiaries. This statutory obligation ensures

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[63] Section 165(1) (c).

[64] Section 165(2).

[65] Section 163(1).

[66] Section 163(2).

that their judgment remains unaffected.[67] Consequently, auditors must disclose any such relationships or interests they may have with the company, along with details of any fees and expenses payable to them, in their report to the company.[68] The Act also mandates the separate disclosure of any additional fees payable by the company for any additional services rendered.[69] Despite these provisions, some critics question the effectiveness of these disclosures, as they depend on the auditor's own assessment and disclosure, which may not always be accurate. Furthermore, there are concerns that auditors may downplay or omit significant relationships or interests, which could compromise their independence. Therefore, while these provisions are a step in the right direction, additional measures may be necessary to ensure full transparency and prevent conflicts of interest.

In the *London & General Bank* case, Lord Justice Lindley emphasized that an auditor's integrity is paramount, and their responsibility is to exercise reasonable skill and care, at a level standard expected of a competent professionally qualified accountant, when verifying the accuracy of a company’s accounting records and the accuracy and completeness of its annual accounts.[70] Auditors are obligated to be truthful and must refrain from certifying anything they do not genuinely believe to be accurate. Additionally, auditors are required to exercise reasonable care and skill in verifying the accuracy of what they certify. This emphasizes the importance of auditors' honesty and diligence in their professional duties.

The duty of care and liability of auditors has been significantly influenced by several landmark cases. *Caparo Industries plc v Dickman*[71] established that auditors have a duty of care to their clients and third parties who may reasonably rely on their audit reports. This broadened the scope of auditors' responsibilities but raised concerns about excessive liability for third parties. Hedley *Byrne & Co Ltd v Heller & Partners Ltd*[72] introduced the concept of negligent misstatement, which has significant implications for

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67 Section 162.

68 Section 163(3)(a).

69 Section 163(3)(b).

70 (No. 2) (1895) 2 Ch. 673 at 682-3.

71 (1990) 2 AC 605.

72 (1964) AC 465.

auditors' duty of care when providing assurance services.

Barings plc (in administration) v Coopers & Lybrand[73] highlighted the role of auditors in detecting fraudulent activities within a company. It emphasized the need for professional skepticism and proactive measures to identify and address fraud risks, but also highlighted difficulties auditors may face, particularly when there is collusion or management override. *Royal Bank of Scotland v Bannerman Johnstone Maclay*[74] highlighted the extent of auditors' liability for failing to detect fraud and errors during audits, emphasizing the importance of diligence and thoroughness. However, it also raised questions about auditors' practical limitations in detecting sophisticated fraudulent activities.

14. THE ROLE OF THE AUDIT COMMITTEE (AC) IN MAINTAINING CG

The AC ensures financial accountability and transparency within organizations. They make substantial contributions to good CG practices by overseeing financial reporting process, ensuring compliance with accounting standards and regulatory requirements and verifying the accuracy and reliability of financial information disclosed to stakeholders. The committee's primary responsibility is to meticulously scrutinize financial reports and disclosures to ensure transparency in financial reporting, which helps to instill confidence in stakeholders regarding the integrity of the company's financial statements.

In addition, the AC evaluates the effectiveness of internal controls and risk management processes, assessing the adequacy of controls to safeguard assets, prevent fraud and ensure compliance with laws and regulations.[75] Collaborating with management, it identifies and addresses control weaknesses, mitigating risks that could compromise financial accountability and transparency. The AC is responsible for several

73 (1997) 1BCLC 427.

74 OHCS 23 Jul 2002.

75 FasterCapital, 'The Role of Auditors In Corporate Governance And Regulatory Compliance' (*FasterCapital*, 2023) https://fastercapital.com/topics/the-role-of-auditors-in-corporate-governance-and-regulatory-compliance.html accessed 1 August 2024.

important tasks. Firstly, recommending external auditors' appointments, selecting qualified audit firms, determining their service period, audit fee, reviewing their independence and evaluating the effectiveness of their audit procedures. The committee communicates with external auditors to monitor the audit process, discuss findings and recommendations and address any concerns or discrepancies identified during audits. They are also responsible for enforcing the rotation of external auditors and audit partners.

The committee must oversee the independence, objectivity and effectiveness of the audit process.[76] They should adhere strictly to relevant standards and best practices, engage in pre-audit discussions with external auditors to define the nature and scope of the audit and review financial information to ensure the integrity of the company's financial statements. The committee should also address any issues arising from interim and final audits, including discussions in the absence of key management personnel. Annually, the committee should conduct a thorough review of the effectiveness of the internal control system. They should take responsibility for overseeing corrective actions to address internal control weaknesses, non-compliance and other identified issues, ensuring compliance with audit recommendations.

The AC is also responsible for managing the internal audit function. They should establish an independent internal audit function tasked with providing objective 'assurance on the quality and effectiveness of the company's internal control, risk management and governance systems'.[77] Reporting directly to the committee, the internal audit function should operate independently from audited activities. The committee should also review its scope, functions, resources and performance evaluations to ensure impartiality, proficiency and due professional care. These measures enhance the quality and credibility of the audit function, reinforcing financial accountability.

Furthermore, the AC is responsible for overseeing whistleblower mechanisms and ensuring channels are available for reporting unethical

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[76] Colombo Stock Exchange, 'Section 9 Corporate Governance' (*Colombo Stock Exchange,* 2023) https://cdn.cse.lk/cmt/upload_report_file/hPLxglBoBHBOZRNs_11Sep2023051530GMT_1694409330850.pdf accessed 7 August 2024.

[77] Audit Committee Charter (*Morgan Stanley*, 2024) https://www.morganstanley.com/about-us-governance/auditcc accessed 7 August 2024.

behavior or financial irregularities. It is crucial to uphold ethical standards and promote a culture of integrity throughout the organization. By doing so, transparency and accountability are promoted. This helps stakeholders understand the organization's financial reporting and governance processes and builds trust, contributing to sustainable stakeholder relationships. In addition, the AC improves its performance by evaluating its governance practices and implementing recommendations for enhancement. The committee's dedication to good CG principles reinforces the significance of financial accountability and transparency within the organization, thereby promoting long-term sustainability.

It is evident that although the traditional role of the AC has been to oversee, monitor, and advise company management and external auditors during audits and the preparation of financial statements, the new role of the AC includes a broader set of duties and responsibilities, focusing on a more proactive oversight approach. This encompasses ensuring the accountability of management as well as internal and external auditors and ensuring that all parties involved in financial reporting and internal controls understand their roles. The AC also seeks input from internal auditors, external auditors, and outside experts when necessary to maintain the objectivity of the financial reporting and internal controls process. This change represents a significant expansion in the AC's responsibilities and the impact it can have.

To ensure effective oversight of financial reporting, risk management and internal controls within organizations, the independence and integrity of the AC are crucial. This can be achieved through several comprehensive measures. Firstly, it is imperative to ensure that the committee's chair is an independent director with expertise in accountancy or audit and majority or all of the AC members are independent directors, who do not have any material relationships with the company or its management.[78] This arrangement guarantees objectivity and minimizes conflicts of interest. The committee may appoint the chief internal auditor as its secretary. Additionally, AC members must possess sufficient financial literacy and expertise. This will enable them to effectively assess complex accounting issues and financial statements, thereby facilitating informed decision-making.

[78] The 2012 corporate governance code of Singapore recommends having a majority of independent directors if the board's chairman is not independent.

It is evident that implementing rotation policies for members of the AC is crucial. Such policies prevent complacency and encourage fresh perspectives, thereby reducing the risk of undue influence or entrenchment. Furthermore, when appointing and overseeing external auditors, it is imperative that an independent selection process is established and led by the AC rather than management. This ensures the integrity and objectivity of the audit process. Periodic assessments of the external audit firm's independence, objectivity, and performance are essential to maintain the audit process's integrity. Moreover, to ensure the external auditor's independence and credibility, guidelines must be established to limit the scope of non-audit services provided by them. Efficient exchange of information is facilitated by direct reporting lines between the AC and key stakeholders. This enhances transparency and accountability. Additionally, transparent reporting of committee activities further builds trust and accountability within the organization. Lastly, strict confidentiality protocols must be in place to safeguard sensitive information, preserving the integrity of decision-making processes. These practices are integral to enhancing CG through effective auditing.

AC members benefit from continuing education to remain informed and effective in their role of oversight, while access to professional resources and expert guidance enhances their ability to address complex issues. The adoption of a comprehensive code of conduct and robust whistleblower mechanisms reinforce ethical standards and promote a culture of integrity within the committee. Furthermore, conducting periodic self-assessments and engaging external experts for independent evaluations helps identify areas for improvement, strengthening the committee's integrity and effectiveness. Implementing these measures upholds the independence of the AC, which ultimately promotes trust and ensures sustainable long-term success by enhancing confidence in financial reporting, risk management and governance processes.

15. CONCLUSION

As previously discussed in this study, CG and auditing serve as fundamental pillars in Sri Lanka's business environment, promoting transparency, accountability and building stakeholder trust amidst evolving regulatory environments. These critical functions are essential for navigating uncertainties and achieving enduring success. However, any lapses in accounting, audit and CG can have profound and significant implications for stakeholders and society as a whole. Such failures erode investor and public trust, casting doubt on auditors and the companies they audit, ultimately affecting market stability and investor sentiment. Moreover, the consequences of failures can extend to legal proceedings, with both auditors and companies facing litigation, intensifying financial pressure and reputational harm. Consequently, the sustainability and future prospects of auditors and companies may be at risk.

Effective CG practices are critical in addressing various challenges faced by corporate entities. These practices promote ethical standards, transparency and accountability, thereby enhancing trust, mitigating risks and contributing to long-term sustainability. In Sri Lanka, regulatory bodies play a crucial role in shaping CG practices. Efforts are focused on aligning standards with global benchmarks to enhance transparency, accountability and investor confidence. To ensure the effectiveness of Sri Lanka's legal framework, strong enforcement mechanisms and a culture of compliance are imperative. Regulatory bodies, law enforcement agencies and judicial institutions play pivotal roles in upholding laws, investigating violations and promoting ethical behavior. Strengthening enforcement capacity and raising awareness through educational programs are essential steps toward developing a culture of compliance and creating a favorable business environment for sustainable economic growth.

Auditing and CG are closely intertwined, fostering responsibility, innovation and stakeholder engagement. This relationship between auditing and CG is mutually beneficial and plays a significant role in influencing the long-term viability of corporate entities. Strengthening enforcement mechanisms, enhancing director education and promoting stakeholder engagement are vital for advancing CG in Sri Lanka and aligning with global standards. In this regard, auditing plays a crucial role in ensuring financial accountability and transparency, with audit committees overseeing financial reporting, external audit processes, risk management, ethical compliance, stakeholder communication and continuous improvement efforts. Auditors evaluate financial performance and vulnerabilities, aiding strategic planning and risk mitigation efforts. CG frameworks prioritize stakeholder interests, promoting sustainable value creation and corporate longevity. Both emphasize continuous improvement and adaptation, enabling companies to navigate uncertainties and capitalize on growth opportunities.

In order to increase its business competitiveness and attract foreign investment, Sri Lanka is working to align its legal framework with global best practices and standards. The country is working on harmonizing its accounting standards with global benchmarks and participating in international initiatives to share knowledge and improve regulatory reforms. However, challenges remain, such as bureaucratic inefficiencies, legislative delays, capacity constraints and enforcement gaps which can slow down the framework's responsiveness. To address these challenges, stakeholders can collaborate to improve regulatory coordination, use technology for compliance and strengthen enforcement mechanisms. Increasing transparency in the legislative process and involving stakeholders in consultations can also enhance responsiveness.

In conclusion, auditing enhances investor confidence and financial reporting integrity. It provides assurance of accuracy, reliability and compliance of financial statements, reduces information asymmetry, protects stakeholder interests and promotes stability in capital markets. By strengthening CG and auditing practices, Sri Lankan companies can achieve future resilience, ensuring sustainable growth and long-term success in a dynamic and competitive environment. Having a well-designed legal framework that can adjust to changing business conditions is crucial for implementing proactive auditing and governance procedures. This legal structure should promote adaptability, innovation, regulatory compliance and stakeholder trust. By doing so, it will help businesses navigate complexities, seize opportunities and maintain long-term sustainability in dynamic and competitive environments.