

# I. Introduction

## 1. Study Background

The 1997-1998 Asian financial crisis exposed structural weaknesses in the banking and corporate sectors of affected countries owing largely to poor governance, a lack of transparency, and weak supervision and regulation.<sup>2</sup>

The Asian Development Bank (ADB) has been taking a number of initiatives to assist Developing Member Countries (DMCs) to overcome these structural problems. The focus on improved governance includes enhancing the effectiveness of public administration and development management at the sector level and in national institutions. Where appropriate, institutional development of the local and provincial agencies and the private sector is also covered. A sound regulatory financial framework and its enforcement, capable institutions, skilled human resources, and effective monitoring and supervision are important prerequisites to an efficient financial structure.

In 2000, under ADB Regional Technical Assistance (RETA) 5877<sup>3</sup>, Diagnostic Studies of Accounting and Auditing (DSAAs) were prepared and published for Cambodia, Mongolia, Pakistan, Papua New Guinea, People's Republic of China, Uzbekistan, and Viet Nam. ADB approved RETA 5980 *Diagnostic Study of Accounting and Auditing Practices in Selected DMCs*<sup>4</sup> for the purpose of carrying out initial studies to identify gaps and weaknesses in accounting and auditing arrangements and to recommend courses of action to overcome these problems. It extends the work conducted under RETA 5877.

## 2. Objectives

ADB has demonstrated its stand on the importance of good governance, through effective financial management, for sustained economic development. This RETA involved a diagnostic review of the existing accounting and auditing support and standards available in the selected

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<sup>2</sup> Zhuang, Juzhong, David Edwards, David Webb, and Ma. Virginita Capulong. 2000. *Corporate Governance and Finance in East Asia: A Study of Indonesia, Republic of Korea, Malaysia, Philippines and Thailand*. Manila: ADB.

<sup>3</sup> *Strengthening Financial Management and Governance in Selected DMCs*.

<sup>4</sup> For \$230,000 approved on 20 March 2001.

DMCs. After carrying out this diagnostic review, the study assessed the need for assistance to improve the current situation. Objectives were to:

- (i) assess the capability and capacity within each country to provide efficient and effective accounting and auditing support to meet international standards and best practices and address the issue of training and capacity enhancement
- (ii) determine the existing accounting and auditing standards of each selected country
- (iii) assess the degree of deviation from International Accounting and Auditing Standards while identifying weaknesses and possible corrective options
- (iv) discuss the fieldwork findings and introduce the concepts of the international standards through workshops, and
- (v) determine the level and type of assistance needed by each country in order to provide acceptable accounting and auditing support to the private and public sectors.

### **3. Scope**

The RETA involved an indepth study of the key issues relating to accounting and auditing support in the selected DMCs, identified gaps and weaknesses that need to be addressed to improve accounting and auditing support, and developed assistance programs in collaboration with other donors to rectify the identified weaknesses. Sri Lanka was one of four countries that participated in the RETA.

### **4. Country Case Study and Workshop**

The first part of the study examined the current accounting and auditing structure and systems adopted in Sri Lanka. It also: (i) analyzed the political, institutional, and regulatory and legal framework on accounting and auditing practice, and the level of enforcement of existing laws, rules, and regulations; (ii) identified gaps and weaknesses in accounting and auditing support available and deviations from international standards; and (iii) identified alternative options to remedy the identified weaknesses, with the objective of eventually them eventually.

The second part of this study disseminated the country-research findings through in-country workshops. Each workshop provided a cross-section of views on the research findings and established ways to move forward to improve financial management and governance in the country.

After carrying out the assessment of Sri Lankan accounting and auditing support, the study findings and recommendations were discussed at a workshop in Colombo on 19-20 July, and at an international workshop at ADB Headquarters in Manila on 5-6 March 2002. This report incorporates feedback from both workshops. Appendix 3 provides further information on the Colombo workshop.

## 5. Sri Lanka

### General

Sri Lanka has a land area of 65,610 km<sup>2</sup> (about the same as Ireland or Tasmania) and is located in the Indian Ocean, just off India's southern tip. In 1948, Sri Lanka's population was only seven million, but between 1963 and 1972 it increased at an annual average rate of 2.3 percent. Since then, the population growth rate has fallen substantially and averaged 1.2 percent from 1995 to 1999.

There are now about 19 million Sri Lankans of whom over one million live in the capital, Colombo. Sri Lanka's population density of 295 people per km<sup>2</sup> is among Asia's highest. The three main ethnic groups are Sinhalese (74 percent), Tamils (18 percent), and Muslims (7 percent). Sinhala and Tamil are national languages, and English is widely used as a link language, particularly in business.

Sri Lanka became a British colony in 1815, following periods of Portuguese and Dutch colonial rule. The island gained independence in 1948 and was renamed Sri Lanka on becoming a republic in 1972.<sup>5</sup> Sri Lanka is a parliamentary democracy, although the President has strong powers. There is a unicameral legislature and both the President and the Parliament are elected for a maximum term of six years.

The Government had hoped to resolve a separatist Tamil insurgency in the north and east through the 1987 peace accord involving India (Indian troops were deployed but later withdrawn). But peace talks between the Government and the Liberation Tigers of Tamil Eelam (LTTE) broke down in 1995 leading to intensified military activity. The Government's priority is to bring the northern and eastern parts of the island back under its control and to negotiate a political settlement with the LTTE. Since the conflict began, over 60,000 Sri Lankans have been killed and more than 600,000

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<sup>5</sup> Niven, Christine, John Noble, Susan Forsyth, and Tony Wheeler. 1999. *Sri Lanka*. Lonely Planet Publications: Australia. pp. 13-14.

have lost their homes—over 170,000 people are living in welfare centers. Indirect costs of the conflict include disruptions to commerce, distortions to labor markets and missed revenues from potential investment and tourism.<sup>6</sup> The Central Bank of Sri Lanka estimates that the conflict reduces Gross Domestic Product (GDP) growth by 2-3 percentage points each year.<sup>7</sup>

Sri Lanka's major exports include garments, tea and diamonds. Major imports include textiles, machinery and transport equipment, consumer durables, food and drink, and petroleum products. Table 1 presents key indicators for Sri Lanka and for other selected countries.

Table 1. Key Indicators for Selected ADB DMCs<sup>8,9</sup>

| Indicator   | Sri Lanka | Fiji Islands | Azerbaijan | Philippines | RMI   |
|---|-----------|--------------|------------|-------------|-------|
| <b>General</b>  |           |              |            |             |       |
| Population ( <i>thousands, 2000</i> )                         | 19,359.0  | 811.0        | 8,049.0    | 78,400.0    | 52.0  |
| Population density ( <i>people per km<sup>2</sup>, 2000</i> ) | 295.0     | 44.0         | 93.0       | 263.0       | 282.0 |
| Urban population ( <i>% of total, 2000</i> )                  | 23.6      | 42.3         | 57.3       | 58.6        | 71.9  |
| Average annual population growth rate ( <i>%, 1995-2000</i> ) | 1.3       | 1.1          | 1.0        | 2.2         | 1.5   |
| <b>Social</b>   |           |              |            |             |       |
| Under-five mortality rate ( <i>per 1000, 1999</i> )           | 15.0      | 18.0         | 16.0       | 31.0        | 63.0  |
| Life expectancy at birth ( <i>years, 1999</i> )               | 74.0      | 67.0         | 71.0       | 69.0        | 65.0  |
| Adult literacy rate ( <i>15-yr+, %, 1999</i> ):               |           |              |            |             |       |
| – Females   | 89.0      | 90.0         | 97         | 95.0        | 97.0  |
| – Males   | 94.0      | 95.0         | 97         | 95.0        | 97.0  |
| Population in poverty ( <i>%, 1995-99</i> )                   | 26.7      | 25.5         | 68.1       | 40.0        | ...   |
| Human Development Index ( <i>1999</i> )                       | 0.74      | 0.76         | 0.74       | 0.75        | 0.56  |
| <b>Economic</b>   |           |              |            |             |       |
| Gross National Product (GNP) ( <i>\$million, 1999</i> )       | 15,578    | 1,848        | 3,705      | 77,967      | 99    |
| GDP per capita ( <i>\$, 2000</i> )                            | 842       | 1,978        | 654        | 959         | 1,890 |
| GDP growth rate ( <i>%</i> )                                  |           |              |            |             |       |
| – 2000  | 6.0       | -9.3         | 11.4       | 4.0         | -2.3  |
| – 1999  | 4.3       | 9.6          | 7.4        | 3.4         | 0.8   |
| – 1998  | 4.7       | 1.4          | 10.6       | -0.6        | -16.0 |
| – 1997  | 6.3       | -0.9         | 8.8        | 5.2         | -9.4  |

<sup>6</sup> World Bank. 2000 September. *World Bank Regional Brief: South Asia*.

<sup>7</sup> Central Bank of Sri Lanka. 2000. *1999 Annual Report*. Government of Sri Lanka.

<sup>8</sup> ADB. 2001. *Key Indicators of Developing Asian and Pacific Countries*. Volume XXXII. Manila: ADB.

<sup>9</sup> ADB. 2001. *Asian Development Outlook 2001*. Manila: ADB. pp. 139-140.

Table 1. Key Indicators for Selected ADB DMCs (*continued*)

| Indicator   | Sri Lanka | Fiji Islands | Azerbaijan | Philippines | RMI     |
|---|-----------|--------------|------------|-------------|---------|
| Consumer Price Index ( <i>Annual % change, 2000</i> ) | 6.2       | 1.1          | 1.9        | 4.4         | -1.9    |
| Fiscal Balance / GDP (% <i>, 2000</i> )               | -9.9      | ...          | -1.0       | -4.2        | -35.5   |
| Total External Debt / GNP (% <i>, 1999</i> )          | 60.3      | 9.3          | 30.0       | 64.8        | ...     |
| <b>Official Development Flows</b>                     |           |              |            |             |         |
| US\$ million ( <i>1999</i> )                          | 343.6     | 23.2         | 207.2      | 295.0       | 62.9    |
| Dollars per capita ( <i>1999</i> )                    | 17.7      | 28.6         | 25.7       | 3.8         | 1,219.0 |
| Percentage of GNP ( <i>1999</i> )                     | 2.2       | 1.3          | 5.6        | 0.4         | 63.5    |

In the 1960s, Sri Lanka had the same per capita income as Korea, Malaysia and Singapore. Thirty years later, these three countries have per capita incomes that are several times higher than Sri Lanka's. Several factors contributed. First, the conflict has taken a heavy social and economic toll. Second, until relatively recently, Sri Lanka had an extremely high population growth rate. Third, public institutions and governance arrangements have gradually weakened since the 1970s. Fourth, Sri Lanka has for many years assigned the public sector a significant role in creating jobs and transferring resources across groups. The size of the public sector has declined slightly over the years, but it continues to dominate the financial sector and utilities, and includes many commercial enterprises. Per capita employment in the public sector is Asia's highest. With productivity in the public sector typically well below that of the private sector, this has meant foregone opportunities in terms of growth and employment.

## Recent Economic Events and Future Prospects

Although the 1997-98 Asian financial crisis affected Sri Lanka's economy, GDP growth rebounded to reach 6.9 percent in the fourth quarter of 1999.<sup>10</sup> This momentum continued and an annual growth rate of 6.0 percent was recorded in 2000. However, the intensified civil conflict since April 2000—combined with political uncertainty and the global economic slowdown—constrained growth in 2001.<sup>11</sup>

<sup>10</sup> ADB. 2001 February. *Country Economic Review: Sri Lanka*. Manila: ADB. p. 1.

<sup>11</sup> ADB. 2001. *Asian Development Outlook*. Manila: ADB. p. 125.

In 2000, the Government broadened the tax base, and rationalized the tax system and expenditure. On the expenditure side, audit and management committees were established to improve financial prudence in public enterprises and statutory agencies, and a separate unit in the Ministry of Finance and Planning was set up to evaluate government expenditure.<sup>12</sup> The intensified civil conflict has resulted in higher security-related expenditures (5.6 percent of GDP) that in turn have put pressure on an already weak fiscal position.<sup>13</sup>

## Challenges

Despite the progress made in financial and corporate sector restructuring in countries affected by the Asian crisis, these efforts have not been followed through adequately. This has diminished business and investor confidence and leaves the financial and corporate sectors vulnerable to external shocks. The current global slowdown is reducing corporate profits and adding distress in the banking sectors. Without resolving bank nonperforming loans and corporate debt overhangs, these economies face the risk of prolonged slow growth.<sup>14</sup>

In the face of the current economic difficulties and the ongoing civil conflict, a stable macroeconomic environment is considered a prerequisite for sustained growth with poverty reduction. To this end, the Sri Lankan Government is implementing key reforms to promote greater private sector development, reduce the fiscal deficit, right-size the civil service, enhance labor market flexibility, restructure state enterprises, and create opportunities for the poor to participate fully in the economic growth process.<sup>15</sup>

These reforms are based upon the Government's *Framework for Poverty Reduction*. The *Framework* advocates a three-point strategy: (i) reducing poverty by creating opportunities for pro-poor growth; (ii) strengthening the social protection system; and (iii) empowering the poor and strengthening governance. With regards to (iii), institutional governance is to be strengthened by upgrading public sector management practices. Macroeconomic governance will be improved by tightening financial

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<sup>12</sup> ADB. 2001. *2000 Annual Report*. Manila: ADB, p. 34.

<sup>13</sup> ADB. 2001 June. *Country Strategy and Program Update: Sri Lanka (2002-2004)*: Manila: ADB, p. 1.

<sup>14</sup> Kawai, Masahiro (World Bank Chief Economist for East Asia). 2001 April 18. *Replay of 1997 Not Likely if Asia Reforms Continue*. As reported in the Singapore Business Times.

<sup>15</sup> ADB. 2001 June. *Sri Lanka: Country Strategy and Program Update (2002-2004)*. Manila: ADB, p. 2.

accountability. Decentralization is to be promoted, although regional fiscal imbalances are addressed and procedures for local government public expenditure management are improved.<sup>16</sup>

## 6. ADB Focus on Financial Governance in Sri Lanka

ADB's Sri Lanka Country Strategy and Program (CSP) was reformulated in June 2001. The CSP Update reflects the Government's reform priorities and provides an assistance program to achieve them.<sup>17</sup>

The Government's governance priorities include creating a policy environment conducive to private sector growth, and shifting the government's role from that of direct producer and service provider to that of regulator. ADB will assist the Government by supporting policy and institutional reforms in the sectors where ADB operations are focused (e.g. road, power, ports, education, water supply and sanitation, environmental and natural resources management and rural finance). ADB will also assist in strengthening public sector management.<sup>18</sup> This includes supporting the implementation of new procurement practices and procedures<sup>19</sup>, and improving public expenditure management at both central and local levels.<sup>20</sup>

ADB operations in finance and industry focus on policy reform and creating a favorable environment for private sector development. The Government has been active in promoting private participation in the economy. Since 1995—when the *Public Enterprise Reform Commission* commenced its work—considerable progress has been made on privatization; particularly in the plantation, telecommunications, ports, power and aviation subsectors. This contrasts with other state-controlled sectors (including roads, railways, urban transport, water supply and sanitation) that are characterized by inefficient management and service provision.<sup>21</sup>

Private sector participation is impeded by: (i) continued public sector involvement in commercial activities; and (ii) a weak enabling environment for private sector participation (e.g., a nonlevel playing field, labor market

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<sup>16</sup> ADB. 2001. *Asian Development Outlook*. Manila: ADB. p. 127.

<sup>17</sup> ADB. 2001 June. *Sri Lanka: Country Strategy and Program Update (2002-2004)*. Manila: ADB. p. 2.

<sup>18</sup> *Ibid.* p. 5.

<sup>19</sup> TA 2950-SRI: *Establishment of the Tender Support Bureau*, for \$1.0 million, approved on 12 December 1997.

<sup>20</sup> TA 3301-SRI: *Strengthening Public Expenditure Management Systems*, for \$3.0 million, approved on 16 November 1999.

<sup>21</sup> ADB. 2000 December. *Sri Lanka: Country Assistance Plan (2001-2003)*. Manila: ADB. p. 17.

rigidities, difficult access to financing and poor governance practices). Accordingly, ADB through the *Private Sector Development Program* (2001-2003), is supporting: (i) further state-owned enterprise privatization and restructuring; (ii) legislative developments to define competition policy and safeguard consumer rights; (iii) initiatives to address labor market rigidities; and (iv) the elimination of market distortions arising from regulatory barriers and the special privileges accorded to state-owned financial institutions.<sup>22</sup>

The domestic capital market has made sound progress since liberalization began in the early 1990s—the market infrastructure compares favorably with other South Asian countries. However, the equities and private debt securities markets remain thin and underdeveloped. ADB's approach to facilitating financial sector development is to: (i) promote good financial market governance through improved understanding of governance principles and best practices, building capacity for good governance, and institutionalizing good governance principles through organizational restructuring; (ii) mobilize financial resources from commercial sources, and when necessary, with support of ADB's guarantee facility, for relending to the private sector through domestic financial institutions; and (iii) develop a network of specialized financial institutions and mainstreaming suitable credit facilities among existing financial intermediaries to target the weaker economic sectors including micro enterprises, small and medium scale industries, retail low-cost housing, and rural areas.<sup>23</sup>

## **7. International Guidelines and Surveillance<sup>24</sup>**

The international community is supporting the development of guidelines, standards and codes to assess financial management and governance practices (see Table 2). Where appropriate, this report compares Sri Lankan arrangements and practices against these benchmarks.

These guidelines, standards and codes—to varying extents—all involve accounting and auditing arrangements. Furthermore, in an attempt to identify and avoid potential crises before they occur, the IMF and the

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<sup>22</sup> *Ibid.* p. 18.

<sup>23</sup> *Ibid.* p. 18.

<sup>24</sup> Narayan, Francis B., Ted Godden, Barry Reid, and Maria Rosa Ortega. 2000. *Financial Management and Governance Issues in Selected Developing Member Countries: A Study of Cambodia, People's Republic of China, Mongolia, Pakistan, Papua New Guinea, Uzbekistan, and Viet Nam*. Asian Development Bank. pp. 12-13.

World Bank have together embarked on a series of *Reports on the Observance of Standards and Codes (ROSCs)*. These reports summarize the extent to which countries observe certain internationally recognized standards.<sup>25</sup> Although ROSCs are intended to be voluntary, the information provided by each country (or not provided, as the case may be) is likely to influence country dealings with international financial institutions, and the level of confidence that the international financial community has in a country.

**Table 2. Selected International Guidelines, Standards and Codes**

| Guideline, Standard or Code  | Promulgated By  |
|--|---|
| • Principles of Corporate Governance   | Organisation for Economic Cooperation and Development (OECD)                                  |
| • Code of Good Practices on Fiscal Transparency  | IMF   |
| • Code of Good Practices on Transparency of Monetary and Financial Policies                    | IMF   |
| • Implementation of the Objectives and Principles for Securities Regulation assessment surveys | International Organization of Securities Commissions' (IOSCO)                                 |
| • International Accounting Standards (IAS)   | International Accounting Standards Board (IASB)   |
| • International Standards on Auditing (ISA)  | International Auditing and Assurance Standards Board (IAASB)                                  |
| • Draft Banking Supervision guidelines   | Basel Committee on Banking Supervision (BCSB) of the Bank for International Settlements (BIS) |

## 8. Report Structure

This report examines financial management and governance issues in Sri Lanka, with a focus on accounting and auditing arrangements. In addition to this introduction, the report has the following chapters:

- Chapter II – **Accounting and Auditing in Sri Lanka** – presents an overview of accounting and auditing arrangements in Sri Lanka. It provides context for the following chapters on professional infrastructure, accounting and auditing standards, accounting and auditing training, and government budgeting and accounting arrangements.

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<sup>25</sup> IMF, September 2000. *Experimental Reports on Observance of Standards and Codes (ROSCs)*. [www.imf.org/external/np/rosco](http://www.imf.org/external/np/rosco)

- Chapter III – **Professional Infrastructure** – describes the professional accountancy infrastructure in Sri Lanka, which comprises regulatory bodies and professional associations.
- Chapter IV – **Accounting and Auditing Standards** – describes the accounting and auditing standards that govern the preparation of external financial reports and their audit.
- Chapter V – **Accounting and Auditing Training** – describes accounting and auditing education and training, including coordination of accountancy education.
- Chapter VI – **Government Budgeting and Accounting** – describes government budgeting and accounting arrangements.
- Chapter VII – **Donor Assistance** – reviews donor coordination mechanisms and discusses donor activities in relation to financial management and governance arrangements.
- Chapter VIII – **Issues and Recommendations** – presents the issues and recommendations that are associated with gaps or weaknesses in accounting and auditing arrangements.
- Chapter IX – **Country Action Plan** – summarizes deficiencies and actions to address these deficiencies. Recommendations are divided into actions that would be better achieved with external assistance; and actions that may be achieved without external assistance.