

II. Accounting and Auditing in Sri Lanka

This chapter presents an overview of Sri Lankan accounting and auditing arrangements. It provides context for the following chapters on professional infrastructure, accounting and auditing standards, accounting and auditing training, and government budgeting and accounting arrangements. The chapter comprises 13 sections:

Part One: Accounting

- 1 – Introduction – identifies historical factors that have influenced accounting arrangements.
- 2 – The ‘Sri Lankan Accounting System’ – describes Sri Lankan accounting arrangements, which include the legislative and institutional framework, accounting bases and accounting information systems.
- 3 – Financial Reporting – describes financial reporting and disclosure requirements.
- 4 – Quality of Sri Lankan Financial Reporting and Disclosure – discusses evidence regarding the quality of financial reporting and disclosure practices and efforts to improve these practices.

Part Two: Auditing

- 5 – Introduction – describes the laws that govern Sri Lankan auditing practices and audit requirements.
- 6 – Auditor Appointment and Dismissal – describes auditor appointment and dismissal by comparing Sri Lankan arrangements to regional norms and international best practices.
- 7 – Auditor Independence – examines the extent of Sri Lankan auditor independence.
- 8 – Audit Reporting Requirements – describes Sri Lankan audit reporting requirements.
- 9 – Auditor Liability – examines auditor exposure to civil litigation.
- 10 – Accounting and Auditing Firms – describes the presence of domestic and international accounting firms in Sri Lanka.
- 11 – Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB) – describes the establishment, authority and activities of SLAASMB.
- 12 – Financial Aspects of Sri Lankan Corporate Governance – identifies and discusses issues relating to financial aspects of corporate governance.
- 13 – Issue Synopsis: Accounting and Auditing – summarizes the issues identified in this chapter.

Part One. Accounting

1. Introduction

For a significant part of its recent history, Sri Lanka has been exposed to many foreign cultures. Of these, the British colonial period, which lasted over two centuries, was the most significant in influencing Sri Lankan accounting arrangements.

Immediately following independence from Britain in 1948, a Commission recommended that an Institute of Chartered Accountants of Ceylon be created. But it was not until 1959 that a Parliamentary Act established the Institute. Sri Lankan financial reporting requirements were primarily based upon British legislation and professional promulgations until 1970, when the Institute of Chartered Accountants of Sri Lanka (ICASL) issued the first Sri Lankan Accounting Standard (SLAS).²⁶

A number of finance companies collapsed in the late 1980s and early 1990s. Many depositors lost their savings as a result and the Government incurred significant fiscal costs through bailouts. In response, the Government established the *Presidential Commission on Finance and Banking* to investigate and strengthen financial sector arrangements. Among other things, the *Commission* recommended that international accounting and auditing standards be adopted to improve financial disclosure. It also recommended that financial reporting be monitored.²⁷

To these ends, the *Sri Lanka Accounting and Auditing Standards Act (No. 15) 1995* was jointly developed by government officials, the accountancy profession and representatives from the commercial and financial sectors. Together with subsidiary regulations, the Act defines certain enterprises as Specified Business Enterprises (SBEs) and governs the preparation, presentation and audit of SBE financial statements. The Act also established the Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB), which—as its name suggests—monitors accounting and auditing arrangements and practices.

Sri Lanka had reasonable accounting arrangements before these improvements were made in response to the finance company crisis. As a consequence of these improvements, Sri Lanka's accounting system

²⁶ Wickramarachchi, M. W. 1978. *Accounting Research Study No. 6: An Examination of Selected Financial Reporting Practices of Public Companies in Sri Lanka*. University of New England, Armidale: Department of Accounting and Financial Management. p. 4.

²⁷ World Bank. 1998 July 31. *Sri Lanka: Financial Sector Reforms*. p. 3.

compares very well with those of other countries: both developing and developed.

2. The ‘Sri Lankan Accounting System’

The ‘Sri Lankan Accounting System’ is strongly influenced by British and more recently international arrangements and practices. The governing legislative and institutional framework is robust and reflects a mixture of government intervention and self-regulation.

Legislative and Institutional Framework

Figure 1 depicts the legislative and institutional framework that governs Sri Lankan accounting and auditing arrangements.

Figure 1. Sri Lankan Legislative and Institutional Framework

Key Governing Laws	
Companies Act (No. 17) 1982 Public Finance Act (No. 38) 1971 Finance Companies Act (No. 78) 1988 Banking Act (No. 30) 1995	Sri Lanka Accounting and Auditing Standards Act (No. 15) 1995 Securities Council Act (No. 36) 1987
Institutions and Primary Functions	
Securities and Exchange Commission (SEC) <ul style="list-style-type: none"> • Administers the Securities Act • Oversees the Stock Exchange 	Central Bank of Sri Lanka <ul style="list-style-type: none"> • Administers the Banking Act 1982 • Approves Bank auditors • Approves accounting and auditing standards for Banks • Determines disclosure requirements for financial institutions
Registrar of Companies <ul style="list-style-type: none"> • Administers the Companies Act 	Institute of Chartered Accountants of Sri Lanka (ICASL) <ul style="list-style-type: none"> • Approves accounting and auditing standards • Supports the activities of the ASC and AuSC
Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB) <ul style="list-style-type: none"> • Monitors the application of accounting and auditing standards 	Institute of Chartered Accountants of Sri Lanka (ICASL) <ul style="list-style-type: none"> • Approves accounting and auditing standards • Supports the activities of the ASC and AuSC
Accounting Standards Committee (ASC) <ul style="list-style-type: none"> • Develops accounting standards 	Auditing Standards Committee (AuSC) <ul style="list-style-type: none"> • Develops auditing standards

The *Sri Lanka Accounting and Auditing Standards Act (No. 15) 1995* is administered by the SLAASMB and requires all SBEs to prepare and present financial statements in accordance with SLASs (see Appendix 8). It also empowers the ICASL to adopt suitable accounting and auditing standards from time to time. These standards are largely derived from IASs. Furthermore, the Act created the SLAASMB to monitor compliance with financial reporting requirements.

The Registrar of Companies administers the *Companies Act (No. 17) 1982*. The Act contains the rules, procedures, and accounting and reporting requirements for Sri Lankan incorporated or registered companies. Company registrations, and filing of accounts and annual returns are done with the Registrar. Under the Act, although the public company accounts are open for public inspection, private company accounts are not. However, private companies must file balance sheets and audited reports with the Registrar.

The Monetary Board of the Central Bank of Sri Lanka administers the *Banking Act (No. 30) 1988* (see Appendix 10). Among other things, the Act empowers the Central Bank to: (i) specify bank disclosure and reporting requirements, including the submission of annual audited statements; (ii) stipulate minimum capital requirements, and (iii) approve bank auditors. SLASs relating to banks must have the concurrence of the Banking Supervision Department of the Central Bank.

The Securities and Exchange Commission (SEC) administers the *Securities Act (No. 36) 1987*. This Act created the SEC and sets out the legal framework for the formalization and regulation of the stock market. Quoted Public Companies (on the Colombo Stock Exchange) are subject to the rules and regulations of the Colombo Stock Exchange constituted under the *Securities Act (No. 36) 1987*.²⁸ The 1990 *SEC Rules* incorporate listing requirements and specify routine and non-routine corporate disclosures (see Appendix 9).

In addition to these key laws, the *Public Finance Act (No. 38) 1971* governs the financial management, reporting and auditing arrangements for public corporations.

Accounting Bases

The financial statements of private and public sector organizations that are classified as SBEs must be prepared using the accrual accounting basis.²⁹ The financial statements of other government bodies are prepared using a cash accounting basis in accordance with Government Financial Regulations.³⁰

²⁸ As amended by the *Securities Act (No. 26) of 1991*.

²⁹ Para. 22, *SLAS Framework*.

³⁰ Government of Sri Lanka. 1992. *Financial Regulations of the Government of the Democratic Socialist Republic of Sri Lanka*. Colombo: Department of Government Printing.

Accounting Information Systems

Accounting information systems range from paper-based manual systems to sophisticated, distributed internet-based systems. Many businesses and public corporations use locally-developed accounting packages.

3. Financial Reporting and Disclosure Requirements

Financial reporting and disclosure requirements are determined by mandatory rules and advisory sources. The mandatory sources were described in the previous section. Advisory sources include the promulgations of other jurisdictions and accounting societies—particularly from international organizations such as IFAC.

Under the *Accounting and Auditing Standards Act 1995*, every SBE (see Box 1) must:³¹

- prepare its financial statements in compliance with SLASs and take all necessary measures to ensure that the financial statements are audited in accordance with SLAuSs with the objective of presenting a true and fair view of the financial performance and financial position of such enterprise
- have the financial statements audited by members of the ICASL holding an Institute-issued Certificate to Practice
- submit a copy of the annual financial statements of the enterprise to the SLAASMB, to enable the Board to determine whether the financial statements have been prepared in compliance with SLASs, and
- furnish to the Board—or to any person authorized by the Board—any information pertaining to its financial statements as may be required by the Board or any person authorized by the Board within such time, as may be specified in a notice issued by the Board or any person authorized by it.

³¹ Ratnayake, Ajith S. (Director-General, SLAASMB). 2000. *Scope and Functions of the Accounting and Auditing Standards Monitoring Board*. www.sec.gov.lk

Box 1. Specified Business Enterprises (SBEs)

The following have been defined as SBEs by the Act and the regulations made under the Act:³²

- Companies licensed under the *Banking Act (No. 30) 1988*.
- Companies authorized under the *Control of Insurance Act (No. 25) 1962* to conduct insurance business.
- Companies carrying on leasing businesses.
- Factoring companies.
- Companies registered under the *Finance Companies Act (No. 78) 1988*.
- Companies licensed under the *Securities Act (No. 36) 1987* to operate unit trusts.
- Fund Management Companies.
- Companies licensed under the *Securities Act (No.36) 1987* to conduct business as stockbrokers or stock dealers.
- Companies licensed under the *Securities Act (No. 36) 1987* to operate a Stock Exchange.
- Companies listed in a stock Exchange licensed under the *Securities Act (No. 36) 1987*.
- Other Companies, which: have a turnover exceeding SLRs 500 Million; at the previous financial year-end had shareholders' equity exceeding SLRs 100 Million; at the previous financial year-end had gross assets in excess of SLRs 300 Million; at the previous financial year-end had liabilities to banks and other financial institutions exceeding SLRs 100 Million; or have a staff exceeding 1,000 employees.
- Public Corporations engaged in the sale of goods or the provision of services.
- A group of companies, any one of which falls within any of the above categories. For this purpose, a group of companies³ means a holding company and its subsidiaries, the accounts of which have to be consolidated under Section 147 of the *Companies Act (No.17) 1982*.

Section 8 of the *Colombo Stock Exchange Listing Rules* stipulates quarterly, half-yearly and annual corporate disclosure requirements. In addition to the submission and publication of audited year-end financial statements, these rules require that entities listed on the main board must make unaudited income statements and balance sheets available within two months of the quarter-end; and entities listed on the secondary board must make unaudited income statements and balance sheets available within three months of the end of each half-year.³³

³² SLAASMB. 2001. *Information of Importance to Companies, Public Corporations, Directors, Managers, Secretaries and other Officers, and Auditors*. Colombo: SLAASMB.

³³ Colombo Stock Exchange. 2000 November. *Listing Rules*. Colombo: Colombo Stock Exchange.

Commercial banks incorporated or established within Sri Lanka and licensed under the *Banking Act (No. 30) 1988* must publish audited annual accounts within five months of the year-end. Sections 36 and 37 of the Act stipulate the content of balance sheets and profit and loss accounts (see Appendix 10). Regulations issued under the Act require provision of (i) monthly statements of assets, liabilities and liquidity ratios; (ii) quarterly statements on nonperforming advances in excess of SLRs 500,000, income and expense items, risk-based capital calculations; (iii) year-end cash flow statements, balance sheets, and income statements, including detailed notes on accounting procedures, commitments, transfers to reserves, depreciation on physical assets, investment values, taxes, and data related to cash reserves.³⁴

The *Public Finance Act (No. 38) 1971* governs the financial reporting of public corporations. Relevant provisions include:

- Public corporations must submit their annual accounts to the Auditor General for audit within four months after year-end. Corporations that fail to comply are liable to a fine of up to SLRs 1,000 (\$11) [Section 13(6)].
- The Auditor General must submit a report on the audit results to the public corporation Chair within eight months of year-end. Copies must be provided to the responsible Minister and the Minister of Finance [Sec 13(7)(a)].
- The Auditor General must submit a report on the audit results to the House of Representatives within ten months of year-end, where the Auditor-General considers that there are matters of interest to the House [Sec 13(7)(b)].
- Within three months of receiving the Auditor General's report, the public corporation's governing body must inform the Auditor General of the steps it proposes to take with regards to the matters raised in the report [Sec 13(8)].
- On completion of the annual audit, the public corporation must provide the following documents to the responsible Minister: the audited balance sheet, the audited operating and profit-and-loss accounts, any comments or observations made by the Auditor General that the Auditor General considers should be published, a statement of accounts and statistics, and the corporation's annual report [Sec 13(14)].
- The appropriate Minister must table these documents in the House of Representatives within ten months of year-end [Sec 14(3)].

³⁴ World Bank. 1998 July 31. *Sri Lanka: Financial Sector Reforms*. p. 29.

- The appropriate Minister may direct the public corporation's governing body to action recommendations made by the Public Accounts Committee to the House of Representatives.

4. Quality of Sri Lankan Financial Reporting and Disclosure

The quality of Sri Lankan financial reporting has improved in the past 20 years—the improvements accelerated in the past five years, in response to the actions taken to avoid a repeat of the finance company crisis. In relation to banks, one assessment concluded that:

Over the past few years, disclosure requirements for banking have substantially improved and appear to be consistent with international standards.³⁵

Furthermore, creative accounting practices include: (i) smoothing; (ii) biasing; (iii) focusing; (iv) gaming or storming; and (v) “illegal” acts.³⁶ The first four practices are common in all countries. A study of Sri Lankan creative accounting practices did not identify any “illegal acts”, thereby indicating that organizations (and their accountants and auditors) tend to work within the rules.³⁷

The ICASL provides impetus for continuous financial reporting improvements through its annual awards for the best annual reports of companies and state corporations. The awards were inaugurated in association with the *Financial Times and News of Ceylon* in 1964 and—in 2001—were available for 16 categories.³⁸

However, although private sector financial reporting and disclosure practices appear sound, this study identified concerns with financial reporting by public corporations. In relation to the 2001 awards, the ICASL President expressed concern that several public sector corporations that had participated in the past had dropped out of the competition, while

³⁵ World Bank. 1998 July 31. *Sri Lanka: Financial Sector Reforms*. p. 29.

³⁶ Birnberg, J. G., L. Turopolec and M. S. Young. 1983. The Organizational Context of Accounting. *Accounting Organizations and Society*. pp. 111-129.

³⁷ Jayasinghe, Manoja. 1998 May. *Nature and Extent of Creative Accounting in Sri Lanka*. Unpublished Manuscript: University of Sri Jayawardanapura.

³⁸ Wickramarachchi, M. W. 1978. *Accounting Research Study No. 6: An Examination of Selected Financial Reporting Practices of Public Companies in Sri Lanka*. University of New England, Armidale: Department of Accounting and Financial Management. p. 5.

others who participated and won certificates before, did not receive a Compliance Certificate.

“Even from among this small number [of public corporations], the Ceylon Electricity Board, which participated this year, did not receive a compliance certificate.

The Ceylon Petroleum Corporation, which not only participated years ago, but also won awards, has not been in the competition for many years. The CWE, which also participated in the past, does not do so now.”

– Ranel T. Wijesinha, ICASL President³⁹

Part Two. Auditing

5. Introduction

Sri Lankan auditing practices developed in line with accounting practices. Consequently, they reflect a strong British influence. SBE financial statements must be audited by ICASL members that hold practising certificates (issued by the Institute). The *Sri Lanka Accounting and Auditing Standards Act (No. 15) 1995* requires auditors to certify in their audit report that the audit has been conducted in accordance with Sri Lankan Auditing Standards (SLAuSs) and that the financial statements have been prepared and presented in accordance with SLAuSs.⁴⁰

Chapter IV describes the process by which the ICASL develops and promulgates SLAuSs—it also compares SLAuSs to ISAs. The application of SLAuSs during audits is monitored by SLAASMB (see page 35). To enable auditors to carry out and document audits in accordance with SLAuSs, the Auditing Standards Committee (AuSC) initiated a project to prepare a Tool Kit—Compendium of Audit Programs. The project was initially undertaken by United States Agency for International Development (USAID) consultants and was completed by a subcommittee of technically knowledgeable audit practitioners. The project, comprising 22 programs, was completed and sent to audit practitioners for comment in December 1999 and released in 2000.⁴¹

³⁹ Wijesinha, Ranel T. (ICASL President), quoted in *The Island Newspaper*. 2000 May 29. Non-participation of Public Corporations at ‘Annual Report’ Competitions Cause for Concern. p. 11.

⁴⁰ Ratnayake, Ajith S. (Director-General, SLAASMB). 2000. *Scope and Functions of the Accounting and Auditing Standards Monitoring Board*. www.sec.gov.lk

⁴¹ ICASL. 2000. *Institute of Chartered Accountants of Sri Lanka 1999 Annual Report*. p. 18.

The following sections examine Sri Lankan auditing practices—Singaporean arrangements are presented for comparison.⁴²

6. Auditor Appointment and Dismissal

Section 13 of the IFAC *Code of Ethics for Professional Accountants* (1996) outlines procedures for communicating between incoming and outgoing auditors.⁴³ Furthermore, ISA 315 states the requirements for communications between predecessor and successor auditors when a change of auditors occurs. It places the initiative for communication with the successor auditor who is required to make specific inquiry, after obtaining permission from the prospective client, of the predecessor auditor as to such matters as management integrity, management disagreements and the reason for change in auditor.

Table 3. Auditor Appointment and Dismissal

Factor	Sri Lanka	Singapore
Nominating party	Shareholders (see below for bank auditor nominations)	Shareholders
Appointing party	Shareholders	Shareholders
Party approving appointment	Bank audits are conducted by approved audit firms	Shareholders and the Monetary Authority of Singapore for financial institutions
Communication between outgoing and incoming auditors	Required by the Code of Conduct and Ethics, before an engagement is accepted	Required before engagement is accepted
Auditors rights to defend position on dismissal or resignation	Written or personal representation to shareholders	Written or personal representation to shareholders, filed with the Registrar of Companies
Compensation on termination	No, other than by the usual commercial practices	Fees owing to outgoing auditor must be paid before incoming auditor can accept the engagement

⁴² The analytical framework used, and the Singaporean information, is adapted from: Favere-Marchesi, Michael. 2000. Audit Quality in ASEAN. *The International Journal of Accounting*, Vol 35(1), pp. 121-149.

⁴³ IFAC. 1996. *Code of Ethics for Professional Accountants*. New York: IFAC.

The 1995 Banking Act amendments specify that banks must select auditors from a list of qualified auditors, compiled by the Banking Supervision Director of the Central Bank, to meet their auditing requirements. The Banking Supervision Director may enlarge the scope of the audit—the auditors must carry out the additional examinations and other work as required.⁴⁴

7. Auditor Independence

The *Code of Ethics for Professional Accountants* states that accountants in public practice should be, and should appear to be, free of any interest that might be regarded as being incompatible with integrity, objectivity and independence.⁴⁵ ISA 220 and the Statement of Policy by the IFAC Council (1992) support periodic peer reviews. Furthermore, Section 8 of the IFAC *Code of Ethics* (1996) relates to the objectivity of auditors with respect to their clients.

As regards auditor independence, in a recent landmark case, the US SEC brought its first successful action for fraud against an auditor in more than twenty years. The case underscored the SEC's concern that "the quality of auditing is being compromised by the amount of (more lucrative) nonaudit work that companies' auditors now perform for their clients."⁴⁶ The ICASL *Committee on Corporate Governance* did recommend that the fees paid for audit and nonaudit work should be separately shown in the annual report, however this recommendation has not been adopted.⁴⁷

Table 4. Auditor Independence

Factor	Sri Lanka	Singapore
Restrictions on relationships: personal commercial financial, or influential	Yes	Some restriction on financial relationships
Restrictions on services provided by audit firms to audit clients (other than the audit)	No (except for restrictions on the auditors providing services that effectively make them company officers or servants)	Accounting, tax advice, consulting, financial and investment advice, corporate recovery

⁴⁴ World Bank. 1998 July 31. *Sri Lanka: Financial Sector Reforms*. p. 31.

⁴⁵ IFAC. 1996. *Code of Ethics for Professional Accountants*. New York: IFAC.

⁴⁶ *The Economist*. 2001 June 23. Andersen's Fairy Tales: A \$7 million fine from the SEC again raises doubts about the independence of auditors. Magazine Article. p. 77.

⁴⁷ ICASL. 1997 December 12. *Report of the Committee to Make Recommendations on Matters Relating to Financial Aspects of Corporate Governance*. Colombo: ICASL. pp. 25-26.

Table 4. Auditor Independence (continued)

Factor	Sri Lanka	Singapore
Rules to avoid low balling	Yes. Incoming auditors are not allowed to accept fees lower than those of outgoing auditors, at least for the first year	Yes
Required rotation of audit partners	No (although the Auditor General informally rotates the private auditors of public corporations on a four-yearly basis)	Every five years for listed companies
Safeguards to objectivity:		
• Challenges to objectivity disclosed	Yes (if significant)	Yes
• Quality reviews	Recently adopted (to be implemented).	Yes
• Internal quality reviews	Yes	No
• Potential threats to objectivity monitored by third party	No	Yes
• Audit committees required	No (but recommended by Colombo Stock Exchange and encouraged by ICASL Corporate Governance Guidelines)	Yes

In other countries, the remuneration paid to auditors for performing non-audit services has to be disclosed in the accounts. Sadly there is no such requirement in Sri Lanka. In some other countries, moves are already underway to prohibit altogether the auditors from providing non-audit services.⁴⁸

In relation to audit partner rotation, the ICASL *Committee on Corporate Governance* recommended that the rotation of audit partners and teams should contribute towards the strengthening of the external audit.⁴⁹ This

⁴⁸ *The Island*. 2000 July 12. Double Standards on Setting Standards! Newspaper Article.

⁴⁹ ICASL. 1997 December 12. *Report of the Committee to Make Recommendations on Matters Relating to Financial Aspects of Corporate Governance*. Colombo: ICASL. pp. 25-26.

recommendation has not yet been adopted. However, the external auditors for state-owned commercial banks are appointed for fixed terms.⁵⁰

The ICASL *Committee on Corporate Governance* recommended that all listed companies should establish Audit Committees and suggested institutional, appointment and reporting arrangements for these committees.⁵¹ To this end, the ICASL, together with the Sri Lanka Institute of Directors and the Chartered Institute of Secretaries, recently prepared and promulgated an Exposure Draft (ED) on *Audit Committees*.⁵²

Under the ADB-sponsored *Private Sector Development Program*,⁵³ the Government will introduce a code of best practice and principles for good governance for public corporations. This code will be based upon the ICASL's guidance in this area. As preliminary implementation of these requirements, Audit and Management Committees have been appointed in public corporations, ministries and departments to review internal control processes and compliance with statutory requirements and government rules and regulations. These committees are also entrusted with reviewing and assisting with the development plans of the organization with a special emphasis on human resource development.⁵⁴

8. Audit Reporting Requirements

ISA 700 *The Auditor's Report on Financial Statements* establishes standards and provides guidance on the form and content of the auditor's report issued as a result of an audit performed by an independent auditor of the financial statements of an entity. Much of the guidance provided can be adapted to auditor reports on financial information other than financial statements.

The ICASL Committee on Corporate Governance recommended that, in view of the failure of a large number of companies, directors should include a statement in the Annual Report indicating that they are satisfied about the company being a going concern. The Committee also suggested that directors should include a specific statement in Annual Reports on

⁵⁰ World Bank. 1998 July 31. *Sri Lanka: Financial Sector Reforms*. p. 21.

⁵¹ ICASL. 1997 December 12. *Report of the Committee to Make Recommendations on Matters Relating to Financial Aspects of Corporate Governance*. Colombo: ICASL. pp. 18-21.

⁵² Ameresekere, Paneetha. 2001 May 1. Private Sector Must Also Demonstrate Good Governance. *The Island*. Newspaper Article. p. 10.

⁵³ ADB Loan No. 1800(SF)-SRI: *Private Sector Development Program*, for \$85 million, approved on 12 December 2000 and Loan No. 1801-SRI: *Private Sector Development Program*, for \$15 million, approved on 12 December 2000.

⁵⁴ MOFP. 2000 October. *Trends in Public Finance: 1999*. Colombo: MOFP. p. 66.

the effectiveness of the company's system of internal control.⁵⁵ Consequently, and in accordance with SLAuS 21 (Going Concern), Sri Lankan auditors must assess whether the entity is a going concern.

Table 5. Audit Reporting

Issue	Sri Lanka	Singapore
In Auditor's Report:		
• Fraud or irregularities	Yes	Yes
• Illegal acts	Yes	Yes
• Internal controls and systems	Yes	Yes
• Maintenance of proper records	Yes	Yes
Reporting to Other Parties:		
• Fraud or irregularities	Yes	Yes
• Illegal acts	Yes	Yes
• Internal controls and systems	No	No
• Maintenance of proper records	Yes	Yes
Standard forms of audit reports required by law	Yes	Yes
Matters to be included in reports specified by law	Yes	Yes
Standard forms of audit reports established by professional bodies	Yes	Yes
Qualified audit reports due to uncertainties	Yes	Yes

9. Auditor Liability

Exposing auditors to civil liability creates strong incentives to raise quality and maintain independence. But there must be a balance between providing this incentive and avoiding a decline in audit services due to excessive litigation costs.⁵⁶

Table 6. Auditor Liability

Issue	Sri Lanka	Singapore
Professional Sanctions:		
• Warning	Yes	Yes
• Reprimand	Yes	Yes
• Fine	Yes	Yes
• Temporary suspension	Yes	Yes
• Permanent exclusion	Yes	Yes
Legal liability cap between contract parties	No	No
Contractual liability cap between contract parties	No	No
Legal liability caps between contract parties and third parties	No	No

⁵⁵ ICASL. 1997 December 12. *Report of the Committee to Make Recommendations on Matters Relating to Financial Aspects of Corporate Governance*. Colombo: ICASL. pp. 23, 25-27.

⁵⁶ Palmrose, Zoe-Vonna. 1988. An Analysis of Auditor Litigation and Audit Service Quality. *The Accounting Review*.(63). pp. 55-73.

10. Accounting and Auditing Firms

Sri Lanka has a developed accountancy profession. All 'Big Five' international accountancy firms are represented together with most of the second-tier international firms. Moreover, there are significant numbers of sole practitioners and partnered firms.

11. Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB)⁵⁷

Introduction

The SLAASMB was established by the *Sri Lanka Accounting and Auditing Standards Act (No. 15) 1995*. The Board has 13 members, including representatives from accountancy bodies, academia, capital regulators, and industry and commerce (see Table 7).

Table 7. SLAASMB Members

Member Type	Number	Nomination and Appointment
Ex Officio Members	1	Registrar of Companies.
	1	Commissioner-General of Inland Revenue.
	1	Director-General of the SEC.
Ministerial Appointees (Appointed Members)	1	An officer of the Central Bank nominated by the Governor of the Central Bank.
	3	Three members of the ICASL selected from among persons nominated by the Institute.
	1	A member of the Sri Lanka Division of the Chartered Institute of Management Accountants (CIMA) of the United Kingdom selected from among three members nominated by the Institute.
	1	A senior lawyer selected from among three senior lawyers nominated by the Bar Association of Sri Lanka.

⁵⁷ The information provided in this section is drawn from the informative article by: Ratnayake, Ajith S. (Director-General, SLAASMB). 2000. *Scope and Functions of the Accounting and Auditing Standards Monitoring Board*. www.sec.gov.lk

Table 7. SLAASMB Members (continued)

Member Type	Number	Nomination and Appointment
	2	Company directors or other persons with extensive managerial experience at senior level in a specified business enterprise one of whom shall be selected from a panel of three names submitted by the Ceylon Chamber of Commerce, and the other from a panel of three names submitted by the Federation of Chambers of Commerce and Industry of Sri Lanka.
	1	A Senior Banker selected from a panel of three bankers nominated by the Sri Lanka Banks' Association.
	1	A person selected from a panel of three persons nominated by the University Grants Commission established by the <i>Universities Act (No.16) 1978</i> to represent the Departments Faculties and Post-graduate Institutes of Accounts or Business Management or Business Administration in Universities coming within its purview.

Membership and Independence

All Board members are either *ex-officio* members (i.e., they hold a specified public office), or are selected from a list of nominees. This appointment process is intended to distance the Board from political influence. The Board takes additional measures to safeguard its independence, which include: (i) Board members must provide a list of SBEs to which they, or their firm, has a connection with either as an auditor, accountant, director or professional advisor; (ii) portions of Board papers relating to these SBEs are omitted from the papers sent to the relevant Board members; (iii) the concerned Board members do not participate in discussions and decisions on the relevant SBEs, and are required to withdraw from the meeting when such issues are taken up; (iv) concerned Board members shall not represent the relevant SBE or the relevant SBE's auditors when SBE representative are invited for a discussion—unless the SBE auditor practices as a sole proprietor; and (v) concerned Board members must not communicate with the Board Chair or the Board Secretariat on issues relating to any matter subject to inquiry or investigation (unless as a sole audit practitioner).

Authority

The Act gives the SLAASMB the authority to: (i) require an SBE or its auditors to provide any information relating to its financial statements; (ii) summon and question any SBE director, officer or auditor on any matter relating to the preparation or presentation of its financial statements; and (iii) conduct investigations or inquiries it considers necessary to perform its duties under the Act. For this purpose, it may call upon any SBE director, officer or auditor to appear at the investigation or inquiry or to produce books or documents as are required for the purpose of the investigation or inquiry.

Activities and Investigations

All SBEs must submit their annual accounts to the Board. The Board reviews annual accounts to identify any apparent non-compliance with SLASs. Investigations are undertaken when doubts arise—the nature of investigations depends on the particular circumstances. Investigations into non-compliance with SLASs may lead to investigations into non-compliance with SLAuSs.

Issues brought to the Board's attention may be concluded: (i) without any further action; (ii) by agreement; (iii) with a direction issued by the Board; or (iv) through legal action. The following actions may result from Board investigations: a direction that the SBE's annual accounts comply with requirements in the future; the requirement that the published accounts be corrected and redistributed; the imposition of a fine by the Board; a court-imposed fine; a court-imposed imprisonment term; or other implications. Box 2 sets out the penalties that can be imposed for non-compliance with the Act.

The year ending 31 December 2000 was the first that the Board had been in active operation. Up until 31 December 2000, it had received financial statements from 341 specific businesses. To date, the SLAASMB has reviewed all financial statements that it received. However, in the future—as the number of received financial statements grows—it intends to adopt a selective sampling approach. As of July 2001, the Board had received very few financial statements from public corporations.

Box 2. Penalties and Other Implications Resulting from Violations

- Every person who fails to comply with the requirements of the Act shall be guilty of an offence under this Act, and shall on conviction after a summary trial ... be liable to a fine not exceeding SLRs 500,000 (\$5,366).
- Where a person is convicted of an offence under this Act and the court holds that the act constituting such offence was done with intention of misleading the shareholders of a specified business enterprise or any financial institution dealing with such specified business enterprise or the Inland Revenue Department or where a licensed commercial bank is convicted of an offence under this Act and the court holds that the act constituting the offence was done with the intention of misleading the depositors of such bank the court may sentence the offender to imprisonment of either description for a term not exceeding five years.
- Where an offence under this Act is committed by a body corporate, any person who is at the time of the commission of the offence, a director, manager, secretary or other similar officer of that body corporate shall be deemed to be guilty of that offence unless he proves that the offence was committed without his knowledge or connivance and that he exercised all such diligence to prevent the commission of that offence as he ought to have exercised having regard to the nature of his functions and all the circumstances of the case.
- Where any accountant of any SBE violates any provision of this Act, it shall be duty of the Board to bring such violation to the notice of any professional body of which such accountant is a member for the purpose of enabling such body to take appropriate action against such accountant.
- Where any SBE has failed to act in compliance with provisions of this Act, it shall be the duty of the Board to bring such fact to the notice of:
 - any authority which is empowered by law to regulate or supervise the activities of such SBEs; and
 - the Inland Revenue Department if the Board considers that such non-compliance has resulted in a substantial reduction of the tax liabilities of such SBEs.

Although the Board identified a large number of deviations from SLASs in the financial statements it had received to 31 December 2000, most were minor disclosure and presentation deviations.

Where significant deviations—which substantially altered an organization’s financial position or financial performance—were detected, the Board took appropriate steps to ensure that the organization took corrective action. Where other departures from SLASs were detected—which were not so significant as to require the use of statutory corrective procedures—letters were sent to the organizations so that the organizations could take corrective action on their own. These letters were not Board directives but were intended to be of assistance. The Board approached financial statement reviews in such a manner as to achieve maximum effectiveness with a minimum of inconvenience to the organizations.

Amalgamation of Monitoring and Regulatory Bodies

In response to complaints from businesses regarding compliance requirements, a Core Group of Business Development was established. The Group includes representatives from: (i) SLAASMB; (ii) the Registrar of Companies; (iii) the SEC; (iv) the Central Bank of Sri Lanka; and (v) the Insurance Regulation Body. The Group recently reported to the Secretary to the Treasury on possibilities for reducing compliance requirements on businesses.

SLAASMB Salary Structure and Staffing Arrangements

The SLAASMB is subject to civil service employment regulations. These limit the Board's ability to pay market salaries to staff, in the absence of a case-by-case dispensation from the Secretary to the Treasury. The issuance of dispensations can take up to two months, during which time the potential employee may find alternative employment.

12. Financial Aspects of Sri Lankan Corporate Governance

In 1999, Sri Lanka's private sector comprised about 36,000 registered private companies and about 2,160 registered public companies; about 75 percent of these were small or medium size companies. After a slow start, privatizations of public corporations accelerated in 1992. ADB supported the Government's privatization program under its *Financial Sector Program* loan in 1990.⁵⁸ By the end of 1999, 75 commercial enterprises and 115 statutory boards and agencies, were still wholly government-owned and employed about 181,000 people (about 3 percent of total employment), with a net asset value close to SLRs 295 billion (\$3.2 billion).

In 1996, the ICASL established a Committee on Corporate Governance to make recommendations on matters relating to financial aspects of corporate governance. The 10-person Committee comprised high-level representatives from ICASL, Registrar of Companies, Colombo Stock Exchange, SEC, Central Bank of Sri Lanka, President's Office, CIMA, Ceylon Chamber of Commerce, and business organizations.⁵⁹

⁵⁸ ADB Loan No. 1051-SRI: *Financial Sector Program*, for \$80 million, approved on 20 November 1990.

⁵⁹ Hussein, Asiff. 1996 March 17. Committee to Study Corporate Governance. *Sri Lanka Sunday Times*.

The Committee finalized its report in December 1997. Among other things, the report recommended that: (i) all listed companies should establish Audit Committees and suggested institutional, appointment and reporting arrangements for these committees; (ii) finance functions be made the responsibility of a specific board director; (iii) company annual reports should include a statement regarding directors' responsibilities for the financial statements in the annual report; (iv) directors should include a specific statement in the Annual Report on the effectiveness of the company's system of internal control; (v) fees paid for audit and non-audit work should be separately shown in the annual report; (vi) the rotation of audit partners and teams would contribute towards the strengthening of the external audit, and (vii) in view of the failure of a large number of companies, directors should include a statement in the Annual Report indicating that they are satisfied about the company being a going concern.⁶⁰

In response to these recommendations:

- ICASL, together with the Sri Lanka Institute of Directors and the Institute of Chartered Secretaries and Administrators (ICSA), recently prepared and promulgated Exposure Drafts (EDs) on *Boardroom Governance* and *Audit Committees*.⁶¹
- ICSA has published a handbook on *Corporate Governance and Guidelines to Best Practice in Sri Lanka*.^{62, 63}
- SLAS 3 *Presentation of Financial Statements* now requires Directors to sign a responsibility clause as part of the Financial Statements.

However, the corporate governance regime for public institutions remains weak as reflected in: (i) lack of management autonomy, commercial orientation and corporate vision; (ii) inflexibility in pricing goods and services; (iii) poor procurement practices; and (iv) non-transparent operations owing to weak disclosure standards and enforcement as exemplified in the often delayed or failed submission of audited annual reports. In April 1999, the Department of Public Finance reported that a number of audited public corporation accounts for 1996 were still

⁶⁰ ICASL. 1997 December 12. *Report of the Committee to Make Recommendations on Matters Relating to Financial Aspects of Corporate Governance*. Colombo: ICASL.

⁶¹ Ameresekere, Paneetha. 2001 May 1. Private Sector Must Also Demonstrate Good Governance. *The Island*. Newspaper Article. p. 10.

⁶² *Sunday Observer*. 2001 July 15. Principles and Guidelines to Good Practice. p. 42.

⁶³ Institute of Chartered Secretaries and Administrators (ICSA). 2001 *Corporate Governance and Guidelines to Best Practice in Sri Lanka*. Colombo: ICSA.

outstanding. Meanwhile, some of the 1997 reports and none of the 1998 reports had been received.⁶⁴

13. Issue Synopsis: Accounting and Auditing Arrangements

Chapter VIII – *Issues and Recommendations* – identifies and describes constraints and proposes corrective actions. These include the following issues from this chapter:

- The Boards of public corporations could be strengthened considerably through the inclusion of at least one Chartered Accountant, or similarly qualified person.
- To strengthen financial management within public corporations, all public corporations should have suitably qualified Chief Financial Officers with senior manager status.
- To improve the financial reporting and disclosure practices of public corporations, the SLAASMB should be required to review the annual reports of all public corporations as a matter of course.
- The *Public Finance Act (No. 38) 1971* sets out reporting and auditing requirements for public corporations. However: (i) public corporations have up to four months after year-end to submit their annual reports to the Auditor-General; (ii) public corporation annual reports can be tabled in parliament as long as 10 months after year-end; (iii) in any case, the time to prepare and audit public corporation annual reports exceeds these deadlines (in practice); (iv) the incentive mechanisms under the Act (e.g., a fine of up to SLRs 1,000) do not encourage compliance; and (v) public corporations do not address issues identified during audits.
- Accountability for financial management could be strengthened by requiring directors to include specific statements in the Annual Report on: (i) the effectiveness of the organization's internal control systems; and (ii) their satisfaction that the company is a going concern.
- Auditor independence is undermined by not requiring separate disclosure of the fees paid for audit and nonaudit work in annual reports.
- The irregular rotation of audit partners and teams would strengthen external audits.

⁶⁴ ADB. 2000 November 21. *Report and Recommendation of the President: Private Sector Development Program (Sri Lanka)—Proposed Program Cluster, Loans, and Technical Assistance Grant*. Manila: ADB. p. 6.

- Allowing the reappointment of external auditors for more than one year would strengthen external audits of state-owned banks.
- The SLAASMB is a key institutional support to good financial governance. But its effectiveness is compromised by staff remuneration arrangements.