

Diagnostic Study of Accounting and Auditing Practices in Sri Lanka

Prepared Under Regional Technical Assistance (RETA)
5980: *Diagnostic Study of Accounting and Auditing Practices
in Selected Developing Member Countries*

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Preface

This report was prepared under Regional Technical Assistance (RETA) 5980: *Diagnostic Study of Accounting and Auditing Practices in Selected Developing Member Countries* for the Asian Development Bank (ADB) by Francis B. Narayan, Lead Financial Management Specialist, ADB; Sarath Lakshman Athukorala, Financial Management Specialist, ADB; and Barry C. Reid, Consultant, ADB. Nihal De Silva, Partner; Lasantha Wickremasinghe, Partner; Naayila Marikkar, Manager; and Natalia Payoe, Secretary, all of B. R. De Silva & Co. (Chartered Accountants), provided excellent research guidance and assistance.

This report describes Sri Lankan accounting and auditing arrangements, identifies deficiencies in those arrangements, and presents recommendations to address those deficiencies. It is part of the ADB series of country Diagnostic Studies of Accounting and Auditing (DSAAAs). In 2000, DSAAAs were completed and published for Cambodia, Mongolia, Pakistan, Papua New Guinea, People's Republic of China, Uzbekistan, and Viet Nam. In 2001-02, DSAAAs were prepared for five further countries, including Sri Lanka.

The contents of the draft report were discussed and debated with representatives from the Government, the private sector and international organizations at a workshop held on 19-20 July 2001 in Colombo. The issues and recommendations were further discussed at an international workshop held on 5-6 March 2002 at ADB headquarters in Manila.

This report should be read in conjunction with the Summary Report, which identifies and examines selected issues in relation to accounting and auditing.¹

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¹ ADB. 2002. *Accounting and Auditing Practices in Selected Developing Member Countries: A Diagnostic Study of Azerbaijan, Fiji Islands, Marshall Islands, Philippines and Sri Lanka*. Manila: ADB.

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Our special appreciation to Ranel T. Wijesinha, President of the Confederation of Asian and Pacific Accountants (CAPA) and former President of the Institute of Chartered Accountants of Sri Lanka (ICASL), who made his valuable time available to discuss issues, facilitate the research process and attend the Manila workshop.

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ADB Diagnostic Studies of Accounting and Auditing

The Asian Development Bank (ADB) publishes this series to: (i) provide reference materials on accounting and auditing for government officials, ADB officials, officials from other donor agencies, and other interested parties; (ii) identify potential actions that the participating government and / or the accounting profession can take to rectify weaknesses, in partnership with donor agencies where appropriate, and (iii) provide the participating country with a benchmark against which to measure their progress in improving financial management and governance arrangements.

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Summary Reports

Accounting and Auditing Practices in Selected Developing Member Countries (DMCs): A Diagnostic Study of Azerbaijan, Fiji Islands, Marshall Islands, Philippines and Sri Lanka. 2002.

Financial Management and Governance Issues in Selected Developing Member Countries (DMCs): A Study of Cambodia, People's Republic of China, Mongolia, Pakistan, Papua New Guinea, Uzbekistan, and Viet Nam. 2000.

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Mekong: **Cambodia** (2000), Lao People's Democratic Republic, Myanmar; Thailand, **Viet Nam** (2000).

Pacific: Cook Islands, Democratic Republic of East Timor, **Fiji Islands** (2002), Kiribati, Republic of the **Marshall Islands** (2002), Federated States of Micronesia, Nauru, **Papua New Guinea** (2000), Samoa, Solomon Islands, Tonga, Tuvalu, Vanuatu.

South Asia: Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, **Pakistan** (2000), **Sri Lanka** (2002).

Southeast Asia: Indonesia, Malaysia, **Philippines** (2002), Singapore.

CURRENCY EQUIVALENTS

(as at 31 March 2002)

Currency Unit – Sri Lankan Rupee (SLRs)
SLRs 1.00 – \$0.01044
\$1.00 – SLRs 95.82

ABBREVIATIONS

AATSL	Association of Accounting Technicians of Sri Lanka
ACCA	Association of Certified Chartered Accountants (UK)
ADB	Asian Development Bank
ASC	Accounting Standards Committee
AusAID	Australian Agency for International Development
AuSC	Auditing Standards Committee
CAPA	Confederation of Asian and Pacific Accountants
CFAA	Country Financial Accountability Assessment
CIDA	Canadian International Development Agency
CIGAS	Computerized Integrated Government Accounting System
CIMA	Chartered Institute of Management Accountants (UK)
CIMASL	Chartered Institute of Management Accountants: Sri Lanka Division
CIPFASL	Chartered Institute of Public Finance and Accountancy of Sri Lanka
CMASL	Society of Certified Management Accountants of Sri Lanka
COPA	Committee on Public Accounts
COPE	Committee on Public Enterprises
CPA	Certified Public / Practicing Accountant
CPE	Continuing Professional Education
CSP	Country Strategy and Program
DMC	Developing Member Country
DSAA	Diagnostic Studies of Accounting and Auditing
ED	Exposure Draft
FASB	Financial Accounting Standards Board
GATS	General Agreement on Trade in Services
GDP	Gross Domestic Product
IAASB	International Auditing and Assurance Standards Board
IAPC	International Auditing Practices Committee
IAPS	International Auditing Practice Statement

IAS	International Accounting Standard
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
ICAEW	Institute of Chartered Accountants of England and Wales
ICASL	Institute of Chartered Accountants of Sri Lanka
ICSA	Institute of Chartered Secretaries and Administrators (UK)
IEG	International Education Guideline
IES	International Education Standard
IFAC	International Federation of Accountants
IIA	Institute of Internal Auditors
IMF	International Monetary Fund
InGAF	Institute of Government Accounts and Finance
INTOSAI	International Organization of Supreme Audit Institutions
IOSCO	International Organization of Securities Commissions
IPFDA	Institute of Public Finance and Development Accountancy
IPSAS	International Public Sector Accounting Standard
ISA	International Standard on Auditing
ISAR	Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting of the UNCTAD
JBIC	Japan Bank for International Cooperation
JICA	Japan International Cooperation Agency
LTTE	Liberation Tigers of Tamil Eelam
MOFP	Ministry of Finance and Planning
OECD	Organisation for Economic Cooperation and Development
PEIS	Public Expenditure Information System
PIP	Public Investment Program
PPBS	Planning, Programming and Budgeting System
PSC	Public Sector Committee
RETA	Regional Technical Assistance
ROSC	Report on the Observance of Standards and Codes
SAI	Supreme Audit Institution
SBE	Specified Business Enterprise
SEC	Securities and Exchange Commission
SLAASMB	Sri Lanka Accounting and Auditing Standards Monitoring Board
SLAS	Sri Lankan Accounting Standard
SLAuS	Sri Lankan Auditing Standard
SLIDA	Sri Lanka Institute of Development Studies
SLR	Sri Lankan Rupee

SME	Small and Medium-Sized Enterprise
SOE	State-Owned Enterprise
TA	Technical Assistance
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
USAID	United States Agency for International Development
WTO	World Trade Organization

Notes

- (i) The fiscal year of the Government ends on 31 December.
- (ii) In this report, \$ refers to US dollars.

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Executive Summary

Background

Sri Lanka is located in the Indian Ocean (just off India's southern tip). In 1948—after more than three centuries of colonization—Sri Lanka gained independence from Britain. Back in the 1960s, Sri Lankans had the same per capita income as Koreans, Malaysians and Singaporeans. With a strategic location, strong institutions, sound infrastructure and comparatively high education standards, they faced a promising future.

Indeed, Sri Lanka has achieved human development outcomes more consistent with those of high-income countries. There are now about 19 million Sri Lankans comprising Sinhalese (74 percent), Tamils (18 percent) and Muslims (7 percent). For almost two decades, attempts have been made to resolve a separatist Tamil insurgency in the island's north and east.

Over 60,000 lives have been lost and more than 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—it is estimated that the conflict reduces GDP growth by 2-3 percentage points each year.

The per capita incomes of Koreans, Malaysians, and Singaporeans are now several times higher than those of Sri Lankans. Several factors contributed. First, the conflict has taken a heavy social and economic toll. Second, until 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 public sector productivity typically well below that of the private sector, this has meant missed growth and employment opportunities.

Despite these factors, Sri Lanka is today South Asia's most open economy, and has a relatively well developed capital market infrastructure. Its per capita income remains the highest in the region, after Maldives. Sri Lanka posted high economic growth rates during the 1990s and weathered the 1997-98 Asian financial crisis reasonably well. However, the global economic slowdown threatens prospects for further improvements.

Challenges and Responses

Sri Lanka's overriding challenge is to resolve the ongoing conflict (security-related expenditures consume 5.6 percent of GDP). Financial governance issues and challenges are centered on the public sector: 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 rigidities, difficult access to financing and poor governance practices).

Particular challenges include: (i) improving the financial governance arrangements for public corporations; (ii) improving the financial reporting of public corporations; and (iii) improving public expenditure management practices. These challenges all involve accounting and auditing arrangements.

In response to these challenges, the Government has been taking a number of initiatives. First, the *Public Enterprise Reform Commission* commenced work in 1995 and has made significant progress on privatizations. The ADB-supported *Private Sector Development Program* is supporting this work and, among other things, will focus on improving corporate governance arrangements amongst public enterprises. Second, the Government has embarked on a program of public expenditure management reform. Among other things, the program's objectives are to improve public sector accounting arrangements and procurement practices.

Accounting and Auditing in Sri Lanka

Sri Lankan accounting and auditing systems are directly influenced by British, and more recently international, arrangements and practices. In 1948, the newly independent country did not automatically accept the inherited arrangements as adequate—a post-independence Commission recommended the creation of a professional accountancy body and improved financial reporting requirements. The professional body was established in 1959 and began issuing accounting standards in 1970.

Confidence in Sri Lanka's accounting and auditing arrangements was severely shaken following the collapse of a number of finance companies in the late 1980s and early 1990s. Many depositors lost their savings and the Government incurred significant fiscal costs through bailouts. In response, the *Presidential Commission on Finance and Banking* was established to investigate and strengthen financial sector arrangements. It recommended that international accounting and auditing standards be adopted to improve financial disclosure and that financial reporting be monitored.

The *Sri Lanka Accounting and Auditing Standards Act (No. 15) 1995* was developed in response to the Commission's recommendations. It governs the preparation, presentation and audit of financial statements. The Act also established the Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB).

The private sector comprises about 36,000 registered private companies and about 2,160 registered public companies. Despite an intensive privatization program, 75 commercial enterprises and 115 statutory bodies remain wholly government-owned.

Today's governing legislative and institutional framework is robust and reflects a mixture of government intervention and self-regulation. Key institutions include: the Registrar of Companies who administers the *Companies Act 1982*; the Central Bank of Sri Lanka which administers the *Banking Act 1995*, approves bank auditors, approves accounting and auditing standards for banks, and determines disclosure requirements for financial institutions; the Securities and Exchange Commission which administers the *Securities Act 1987* and oversees the Stock Exchange; and the SLAASMB which administers the *Sri Lanka Accounting and Auditing Standards Act 1995* and monitors the application of accounting and auditing standards. In addition, the *Public Finance Act 1971* governs the financial management, reporting and auditing arrangements for public corporations.

Commentators have concluded that the quality of Sri Lankan private financial reporting is sound. SLAASMB's activities underpin ongoing improvements to financial reporting. The accountancy profession's annual awards for the best annual reports of companies and state corporations reinforce these activities. Furthermore, the profession is pushing for further improvements, including the establishment of audit committees and the introduction of audit partner rotation. Indeed, Sri Lanka's accounting and auditing arrangements compare very well with those of other countries: both developing and developed—at least for the private sector.

In contrast, public corporation financial reporting and governance practices are poor. In particular, disclosure standards are deficient and compliance with these standards is weak as evidenced by delayed or failed submission of audited annual reports.

Professional Infrastructure

The colonial government established Sri Lanka's first accountancy body—the Accountancy Board—in 1941. Those who passed the Accountancy Board's examinations were called 'Ceylon Registered Accountants'. The

enactment of the *Institute of Chartered Accountants Act (No.23) 1959* established the Institute of Chartered Accountants of Sri Lanka (ICASL) as the national professional accountancy body.

Today, the ICASL has 2,170 members, comprising Associate and Fellow Chartered Accountants. The Institute's qualification criteria meet international guidelines, with the exception of continuing professional education requirements (which conform to UK practices). However, these criteria have been criticized as unnecessarily high in that they restrict the availability of qualified accountants in the face of pressing national needs and emigration.

Other Sri Lankan accountancy bodies include the Association of Accounting Technicians of Sri Lanka (AATSL), the Society of Certified Management Accountants of Sri Lanka (CMASL), the Institute of Internal Auditors (IIA), and the Institute of Public Finance and Development Accountancy (IPFDA). Membership of the IPFDA is by virtue of career experience and position—specific academic qualifications, professional examinations and practical experience are not required.

Foreign professional accountancy bodies have a strong and growing presence in Sri Lanka. Their success in establishing operations reflects strong historical connections with Britain and a desire by many Sri Lankans to have exportable qualifications—many of their members hold concurrent membership with ICASL. The two most significant bodies are the Association of Certified Chartered Accountants (ACCA)(UK) and the Chartered Institute of Management Accountants (CIMA)(UK).

Accounting and Auditing Standards

Before 1970, Sri Lankan financial reporting requirements were primarily based upon the prescriptions of the *Companies' Ordinance of Ceylon*, UK legislation and the recommendations of the Institute of Chartered Accountants of England and Wales (ICAEW). In 1970, the ICASL issued the first Sri Lankan Accounting Standard (SLAS). But the use of SLASs was not legally mandated until 1995, other than for publicly quoted companies, financial institutions and insurance companies.

In addition to tightening financial disclosures, the *Sri Lanka Accounting and Auditing Standards Act 1995* provided for the establishment of the Statutory Accounting Standards Committee (ASC) and the Auditing Standards Committee (AuSC). The ASC and the AuSC operate under the auspices of ICASL.

The ASC's accounting setting-standard process is broadly similar to that of the International Accounting Standards Board (IASB) and

focuses on reviewing International Accounting Standards (IASs) for adoption in Sri Lanka. Twenty-eight SLASs were effective as of 30 June 2001—these include only minor divergences from IASs which, when they do occur, are disclosed as part of the SLAS. All Sri Lankan companies must prepare SLAS-compliant financial reports. Adjustments are then applied to these financial reports to derive corporate income for taxation purposes.

The AuSC promulgates Sri Lankan Auditing Standards (SLAuSs), which are based directly upon the pronouncements of the International Auditing and Assurance Standards Board (IAASB). The promulgation process is similar to that for SLASs.

Education and Training

The Government Technical School (Ceylon Technical College) offered Sri Lanka's first commerce course in 1908. Sri Lanka has primarily relied on professional bodies, rather than universities, for accountancy training—it was not until 1992 that the Sri Jayewardenepura University established a comprehensive Bachelor Degree program in accountancy. This situation reflects an historical reluctance on the part of the universities to provide accountancy courses, which is mirrored by the profession's reluctance to recognize university qualifications.

Following independence, the Government recognized that technicians and professionals were necessary for economic development—to this end it established the *Commission of Inquiry on Technical Education* in 1963. The *Commission* identified shortages in the availability of financial and cost accountants. ICASL responded by reviewing its admission procedures and membership subsequently increased.

In 1993, a study concluded that certain key reform programs were being impeded by the severe shortage of financial management personnel. It estimated that there was a shortfall of 500-1,000 professional accountants and 1,000-3,000 accounting technicians. Moreover, the study identified fundamental flaws in degree, diploma and certificate course structures—specifically there were mismatches between curricula and job slots. In response, the ADB-supported *Financial Management Training Project* supported improvements to accountancy education and training in: (i) universities; (ii) technical institutions; (iii) professional bodies; and (iv) specialist institutions (particularly the Institute of Government Accounts and Finance: InGAF). The *Financial Management Training Project* addressed some supply-side issues in accountancy education and training. Meanwhile,

demand for accountancy education remains high—only the very best students are able to meet the requisite entrance grades.

There is no evidence that skills shortages have abated—particularly in the public sector. If anything, emigration and attempts to improve public sector accountability and transparency have exacerbated the effects of these shortages.

Government Budgeting and Accounting

The inefficiency and ineffectiveness of Sri Lanka's enormous government bureaucracy—together with the ongoing civil conflict—fundamentally limit the country's ability to realize its development potential. Despite a reduction in size over the past two decades, per capita employment in the public sector remains Asia's highest.

In the absence of fundamental civil service reforms or a curtailment of the conflict, the Government has minimal room for pursuing fiscal savings. Attempts to initiate civil service reforms in the early 1990s were unsuccessful—government efforts have subsequently refocused on improving public sector accountability and transparency. Among other things, objectives include: (i) establishing clear priorities and objectives for government organizations; (ii) better defining roles and accountabilities; (iii) improving interfaces between government agencies, service users, and the general public; (iv) improving flexibility through effective delegation of authority; (v) strengthening the institutional framework and procedures for strategic management; and (vi) improving the monitoring and evaluation of performance.

The legal framework for government finance comprises: Chapter XVII of the 1978 *Constitution*; the *Public Finance Act (No. 38) 1971*; and the Financial Regulations promulgated by the Ministry of Finance and Planning. A primary objective of the ADB-supported Public Expenditure Management project was to develop a new Public Finance Act—however, this activity has been postponed as part of the refocusing of the technical assistance.

In the 1970s, the Sri Lankan Government adopted the Planning, Programming and Budgeting System (PPBS) approach to public expenditure management. However, the system has changed little since its implementation. A series of detailed rules and input controls have developed in the meantime. Budgeting and reporting are conducted on a cash accounting basis. Two computerized systems have been developed to manage public expenditure. A primary objective of the ADB-supported Public Expenditure Management Project was to identify user requirements, and develop

specifications, for a new public expenditure information system (PEIS). This activity has been de-emphasized as part of the refocusing of the technical assistance. Activities now focus on upgrading the capacity of existing systems.

Existing public management arrangements impede Sri Lanka's development. However, these arrangements can only be improved if there are sufficient numbers of suitably skilled and motivated accountants in the public sector. This is not currently the case.

Donor Assistance

ADB is supporting broad governance activities through technical assistance and loans. Directly relevant activities include:

- Loans 1800-SRI and 1801-SRI: *Private Sector Development Program* (\$100 million: 2001-2004). This program is intended to promote private initiative and enhance the performance of financial markets.
- Loan 1275-SRI: *Financial Management Training Project* (\$13 million: 1994-1999). This project provided basic computing expertise and skills to a substantial number of civil servants at the national and sub-national levels. It had had three components: (i) development of the Sri Lanka Accountants Service and associated accountancy training; (ii) specialized training in financial management, auditing and computers; and (iii) professional development and training. The project supported the development of InGAF and the preparation and delivery of a variety of training materials.
- TA No. 3301-SRI: *Public Expenditure Management Systems* (\$3 million: 2000-2002). This TA was originally intended to support improvements to public expenditure management through five closely related subprojects: (i) public expenditure information system, (ii) public investment program, (iii) medium-term expenditure framework, (iv) human resource management, and (v) revised Public Finance Act and internal audit. However, in 2001 the TA was refocused in terms of both scope and objectives.
- TA No. 2616-SRI: *Public Administration Reform* (\$0.275 million: 1996). This TA assisted the government to review public administration structures, identify key issues and problems, and formulate a number of strategic design alternatives based on the identified problems.
- TA No. 705-SRI: *Accounting and Auditing Education Master Plan* (\$0.158 million: 1986). This TA assisted the government to develop an accounting and auditing education master plan. The recommendations of the master plan—regarding the need for middle-level financial

personnel—were noted by the Government and the Association for Accounting Technicians of Sri Lanka (AATSL) was subsequently established in 1987.

The **World Bank** is supporting modernization of the Central Bank of Sri Lanka (CBSL) through a \$30.3 million credit. The World Bank limited lending to the financial sector during the 1990s, due to the “Government’s unwillingness to privatize the two large state banks.” Technical assistance to strengthen government auditing and accountability processes is also planned for 2002. The objectives of the assistance are to: (i) strengthen and reorganize the department, and (ii) develop a separate Audit Act to underpin these activities.

Although a UNDP-funded project supported activities to initiate broad-based civil service reforms, other considerations—including the attention and resources absorbed by the civil conflict—limited the effectiveness of these activities. The Canadian International Development Agency (CIDA) provided assistance to support the establishment of the Society of Certified Management Accountants of Sri Lanka (CMA). **Japan** is the largest donor to Sri Lanka—it does not directly support financial management and governance activities, but provides indirect support through Japan-based education and training on financial and public management. The United States Agency for International Development (USAID) has provided support for the development of financial markets and technical assistance to ICASL to enhance the accounting and auditing standards of large and small audit firms, and improve the compliance and monitoring activities of the SEC.

Issues and Recommendations

This Diagnostic Study of Accounting and Auditing identifies issues and recommendations that are associated with gaps or weaknesses in accounting and auditing arrangements. Issues are separated into: (i) those that are able to be resolved without external assistance; and (ii) those that are better able to be resolved with external assistance.

This study concludes that, although Sri Lanka had reasonable financial management arrangements before the finance company crisis, as a consequence of the subsequent corrective improvements, these arrangements now compare very well with those of other countries: both developing and developed—at least for the private sector. In contrast, public corporation financial governance practices are poor—as are other public sector accounting arrangements.

- In the case of **public corporations**, several recommendations are made to strengthen governance. Most can be achieved with minimal resources and effort—for instance, appointing financial specialists to public corporation boards and raising the status of Chief Financial Officers. Others are more complex and will take time, such as strengthening the legislative regime that underpins transparency and parliamentary accountability.
- Regarding the **core public sector**, significant efforts are being made to address a plethora of vital issues. Most of these initiatives are critically dependent on the availability of sufficient numbers of suitably skilled and motivated accountants in the public sector. To this end, this study recommends establishing appropriate professional qualifications for public sector accountants and establishing associated retraining courses.

The study makes other recommendations. However, the issues that they are intended to address are not as critical. They include, for instance, relatively minor enhancements to director accountability and the introduction of mandatory continuing professional education for Chartered Accountants.