IX. Accounting and Auditing Practices in Sri Lanka

1. 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 activity (e.g., a non-level 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, 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 others things, will focus on improving corporate governance arrangements amongst public enterprises. Second, 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.

2. 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 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 intense 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 SEC 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.

3. 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 CPE 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, the Institute of Internal Auditors (IIA), and the Institute of Public Finance and Development Accountancy (IPFDA). IPFDA membership 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 Sri Lankan presence. 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 ICASL memberships. The two most significant bodies are the Association of Certified Chartered Accountants (ACCA)(UK) and the Chartered Institute of Management Accountants (CIMA)(UK).

4. 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 ICASL auspices.

The ASC's accounting setting-standard process is broadly similar to that of IASB and focuses on reviewing 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, which are based directly upon IAASB pronouncements. The promulgation process is similar to that for SLASs.

5. 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 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, 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.

6. 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, 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.

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.

7. 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* ($100.0 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* ($13.0 million: 1994-1999). This project provided basic computing expertise and skills to a substantial number of civil servants at the national and subnational 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* ($3.0 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 was subsequently established in 1987.

The **World Bank** is supporting modernization of the Central Bank of Sri Lanka through a $30.3 million credit. TA 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. **CIDA** provided assistance to support the establishment of the Society of Certified Management Accountants of Sri Lanka. **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. **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.

8. Issues and Recommendations

This study concludes that, while 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 CPE for chartered accountants.

Each study recommendation—and the issues that it is intended to address—is summarized below. The Sri Lankan DSAA report provides further detail.

Strengthen Government Accounting and Auditing

There is a critical shortage of suitably skilled and motivated accountants and auditors in the public sector. The *Financial Management Training Project* developed training materials, strengthened training organizations and trained government accountants and auditors. It also strongly recommended the establishment of sound professional qualifications.[73] However, government accountants and auditors still do not have adequate or appropriate professional qualifications or representation. For instance, IPFDA membership is attained by virtue of career experience and position. Membership does not require specified academic qualifications, professional examinations, practical experience or CPE requirements. The establishment of suitable bookkeeping and accountancy certifications would provide: (i) stepping stones to higher professional qualifications; (ii) measures to gauge competence to undertake bookkeeping and accountancy tasks; and (iii) professional career targets. It is **recommended** that assistance be provided to support: (i) the establishment of strong professional body for public sector accountants and auditors—while this body might continue under the auspices of IPFDA, it must be associated with a reputable, established professional organization if it is to be successful. To this end, ICASL successfully supported the establishment of the Association of Accounting Technicians of Sri Lanka. Given this proven success, ICASL would be the ideal parent or partner for this public sector professional organization; (ii) the design and establishment of an appropriate

[73] Loan 1275: *Financial Management Training Project*, for $13 million, approved on 29 November 1993.

range of professional bookkeeping and accountancy qualifications; (iii) the development of licensure criteria and examinations for each qualification; (iv) the development of educational materials to support the qualifications.

Strengthen Public Corporation Accountability through Legislative Amendments

The existing *Public Finance Act (No. 38) 1971* provides a weak accountability regime for public corporations. In particular, reporting and auditing timeframes are lax. Moreover, the Act's weak incentive mechanisms for compliance further dilute the regime's strength. For instance, public corporations that submit late financial statements are liable for a small fine of not more than SLRs1,000 ($11) [Section 13(6)]. Requiring public corporations to report to Parliament on the actions that they are taking to address audit issues would strengthen compliance incentives. An effective report would briefly: (i) describe each issue; (ii) describe the actions planned to address each issue; (iii) specify the timeframe in which each issue will be addressed; and (iv) provide the name and position of the person who is responsible for implementing the corrective action. It is **recommended** that assistance be provided to review the legislation governing public corporations and to draft a Public Corporations Act. The revised legislation should: (i) impose tighter reporting timetables on public corporations; and (ii) strengthen compliance incentives.

Appoint Financial Specialists to Public Corporation Boards

Public corporation boards do not usually include suitably qualified financial appointees. It is **recommended** that assistance be provided to design and establish mechanisms that ensure that board appointees of public corporations include at least one Chartered Accountant, or a similarly qualified person. Efforts should first focus on commercial and then move to non-commercial public corporations. The design should consider legislative amendments to the *Public Finance Act (No. 38) 1971* to set out appointment and removal processes. Furthermore, nominees for board appointment should be selected from an ICASL-provided shortlist.

Strengthen Public Corporation Internal Auditing and Controls

Public corporations have weak internal auditing functions and internal control systems. Furthermore, very few have effective audit committees. It is **recommended** that assistance be provided to: (i) strengthen the internal auditing functions and internal control systems of public corporations; and (ii) establish audit committees within public corporations.

Publish a Quarterly Scorecard of Public Corporation Reporting

Despite the weak accountability regime for financial reporting, public corporations have difficulty providing timely annual reports. As a short-term measure, a publicly available scorecard of public corporation reporting would provide impetus for reporting improvements. It is **recommended** that assistance be provided to support the development of a scorecard on public corporation reporting. Such a scorecard might be prepared and published by the Ministry of Finance and Planning, within two weeks of each quarter-end. The scorecard would group public corporations by responsible Minister and: (i) provide the corporation Chairperson's details; (ii) identify where the annual report is at, in terms of the reporting and auditing process; and (iii) highlight where deadlines have been exceeded.

Create Chief Financial Officer Positions in Public Corporations

Financial management is given low priority by, and has poor status within, public corporations. It is **recommended** that all public corporations should have suitably qualified Chief Financial Officers with senior manager status.

Require SLAASMB Review of all Public Corporation Annual Reports

SLAASMB currently reviews all the annual reports that it receives. This universal review will be replaced by selective sampling as operations move to a steady state. Given the Board's resources and authority, it can plan a key role in strengthening public corporation financial reporting and disclosure practices. It is **recommended** that SLAASMB review all public corporation annual reports as a matter of course.

Enhance Director Accountability

SLAS 3 *Presentation of Financial Statements* requires directors to sign a responsibility clause as part of the financial statements. Accountability for financial management could be strengthened by requiring directors to include specific statements in the annual report on: (i) whether they have taken all necessary steps to ensure that the organization's internal control systems are adequate; and (ii) their satisfaction that the company is a going concern. It is **recommended** that company directors be required to include specific statements in the annual report on: (i) the organization's internal control systems; and (ii) their satisfaction that the company is a going concern.

Close the Emerging Gaps Between SLASs and IASs

A gap has begun to emerge between SLASs and IASs. In the absence of corrective actions or arrangements, this gap will widen during the coming four years as the IASB reviews existing IASs and issues new standards. One possible corrective option would be to prepare a very brief SLAS for each IAS that stipulates: (i) the effective date of the SLAS (IAS); and (ii) any modifications that apply for Sri Lankan purposes. This approach would reduce standard-setting efforts and costs, and enable the gap to be closed between IASs and SLASs. It is **suggested** that SLASs be promulgated as overlay regulations rather than as amended IASs.

Enhance Auditor Independence and Objectivity

Auditor independence is undermined by not requiring separate disclosure of the fees paid for audit and nonaudit work in annual reports. Furthermore, the regular rotation of audit partners and teams would strengthen external audits. It is **recommended** that auditing practices be reviewed in line with emerging international best practice, and that in particular: (i) fees paid to auditors for audit and nonaudit work be separately disclosed in annual reports; (ii) ICASL review its rules regarding the provision of nonaudit services by auditors; and (iii) regular rotation of audit partners and teams be mandated.

Make CPE Mandatory for Continuing ICASL Membership

IFAC and ISAR recommend a minimum of 30 hours CPE per year, or a minimum of 90 hours in every three-year period of structured learning activity.[74] In contrast, CPE is not a mandatory requirement for continuing ICASL membership. It is **recommended** that ICASL require that members undertake CPE as a condition of membership continuation.

[74] IFAC. 1998 May. International Education Guideline (IEG) 2: Continuing Profession Education. New York: IFAC.

Enhance Institutional Support for Good Financial Governance

The SLAASMB is a key institutional support to good financial governance. Its effectiveness is compromised by remuneration arrangements. It is **recommended** that SLAASMB remuneration arrangements be investigated to ensure that this key organization is able to recruit and retain suitably qualified and experienced personnel.

Provide Resources to the ICASL for Standing-Setting Activities

There is a significant public good component to the standing-setting activities of ASC and AuSC, which are supported entirely by the ICASL. In 1995, the *Presidential Commission on Finance and Banking* recommended that resources be appropriated to ICASL to support ASC's activities, however no action was taken. It is **recommended** that funding be appropriated to ICASL to support accounting and auditing standard-setting activities.

Advocate Changes to IASB Copyright and Pricing Policies

The IASCF copyrights IAS and associated guidance materials. Many developing countries, including Sri Lanka, are moving towards IASs. Investors, lenders, academics, practitioners, and regulators should have access to IASsand associated materials. The IASCF's copyrighting and pricing policies effectively limit this access. It is **recommended** that ADB raise this issue with other multilateral and bilateral donor organizations, so that a joint approach may be made to the IASB and the international accountancy profession.

Encourage the Development of Financial Reporting Standards for SMEs

IAS has been developed on a one-size-fits-all basis. For instance, IAS 19 *Employee Benefits* requires that actuarial valuations be undertaken of certain employee benefits. It is **recommended** that ADB, together with other multilateral development banks, should encourage efforts to develop a financial reporting regime for SMEs.