PUBLIC FINANCIAL MANAGEMENT SYSTEMS—SRI LANKA

KEY ELEMENTS FROM A FINANCIAL
MANAGEMENT PERSPECTIVE

MARCH 2018

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ISBN 978-92-9261-070-8 (print), 978-92-9261-071-5 (electronic)
Publication Stock No. TCS189197-2
DOI: <http://dx.doi.org/10.22617/TCS189197-2>

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Acknowledgments

The project team—Aman Trana, director, Public Financial Management Division; Srinivasan Janardanam, principal financial management specialist; Anouj Mehta, principal financial management specialist; Akmal Nartayev, senior financial management specialist; Mocktar Adamou-Ndiaye, financial management specialist; Myra Ravelo, senior financial management officer from the Procurement, Portfolio and Financial Management Department of the Asian Development Bank (ADB); and former staff Abbas Kizilbash and Jessana Yanuario—would like to thank the following government officials who met with Nishan Mendis (consultant) and made valuable contributions to this report.

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The assistance of the following ADB staff is likewise gratefully acknowledged: Taisuke Miyao, senior procurement specialist; Tadateru Hayashi, senior economist; Jayamali Amila Ranaweera, financial control officer; Gi Soon Song, principal social sector specialist; Anoukgrahadha Tyagarajah, operations assistant; and former ADB staff Sherazade Shafiq and Sarath Muthugala.

Abbreviations

ADB	–	Asian Development Bank
AGD	–	Auditor General's Department
CAO	–	chief accounting officer
CBG	–	criteria-based grant
CBSL	–	Central Bank of Sri Lanka
CIGAS	–	Computerized Integrated Government Accounting System
COPA	–	Committee on Public Accounts
COPE	–	Committee on Public Enterprises
CSDRMS	–	Commonwealth Secretariat Debt Recording and Management System
CTLA	–	Controller's Department, Loan Administration Division, ADB
DLI	–	disbursement-linked indicator
DMA	–	Department of Management Audit
DNB	–	Department of National Budget
DNP	–	Department of National Planning
DSA	–	Department of State Accounts
ERD	–	Department of External Resources
FGIA	–	first-generation imprest account
ICASL	–	Institute of Chartered Accountants of Sri Lanka
IPSAS	–	International Public Sector Accounting Standards
ITMIS	–	Integrated Treasury Management Information System
LFIS	–	Loan Financial Information System
MLGPC	–	Ministry of Local Government and Provincial Councils
MoF	–	Ministry of Finance
PDD	–	Public Debt Department
PMU	–	project management unit
PSDG	–	province-specific development grant
RBL	–	results-based lending
SGIA	–	second-generation imprest account
SLAS	–	Sri Lanka Accounting Standards
SLPSAS	–	Sri Lanka Public Sector Accounting Standards
SLRM	–	Sri Lanka Resident Mission
TGIA	–	third-generation imprest account
TOD	–	Department of Treasury Operations

I. Introduction

This report is designed to support fiduciary risk assessments of projects financed by the Asian Development Bank (ADB). It provides information about Sri Lanka's public financial management systems in funds flow analysis, accounting, and auditing and related matters that will be particularly useful to project officers as they process and implement ADB-funded projects. The information in this report may be advantageous in financial management assessments of executing and implementing agencies, as well as in the design of disbursement, reporting and auditing, and other financial management arrangements.

Foreign aid to the Government of Sri Lanka can take the form of loans or grants. Loans can be either foreign loans to the government or guarantees by the government for foreign loans to public corporations and public enterprises. Whether the government decides to award a subgrant or to onlend for a proposed project depends mainly on the ability of the project to generate revenue. Subgrants finance the budget of government ministries, departments, and agencies. Subgrant funds are allocated through the central budget and do not have to be repaid by the project owner. In onlending, funds are loaned from the central budget, and the government enters into onlending agreements with the project owners, who must repay the loans. Guarantees to public corporations and public enterprises are considered off-budget items and are treated as contingent liabilities of the government.

II. Key Players

A. Ministry of National Policies and Economic Affairs

Department of External Resources

The Department of External Resources (ERD) is the national counterpart of the development partners. It is headed by a director general, who is assisted by four additional directors general and eleven directors supervising 14 divisions, including an Asian Development Bank division. The ERD is mainly responsible for mobilizing and coordinating foreign development assistance. Its key functions are as follows:¹

- (i) Consulting with development partners to identify development assistance strategies and priorities.
- (ii) Coordinating the annual country aid programming activities of development partners in consultation with line ministries and agencies.
- (iii) Preparing project pipelines for foreign financing in consultation with line ministries, agencies, and the Department of National Planning (DNP) in line with the government's Public Investment Program and its Economic Policy Statement.
- (iv) Coordinating the activities of donor missions from fact finding to appraisal.
- (v) Negotiating foreign aid and arranging for loan and grant agreements to be signed and to take effect, including negotiating loans with development partners and lending agencies; obtaining government approval and authority for the signing of agreements; signing subsidiary loan agreements with the implementing agencies; and fulfilling conditions before the loan agreements take effect.
- (vi) Overseeing the implementation of donor-funded projects by coordinating activities connected with review missions fielded by development partners and following up recommended actions; participating in steering committees set up by line ministries to monitor the implementation of foreign-funded projects; and reviewing the implementation of projects together with the development partners.
- (vii) Managing the government's external debt database, the Commonwealth Secretariat Debt Management and Recording System, by maintaining the foreign loan and grant commitments, disbursements, and repayments database for various users such as line ministries, the Treasury, the central bank, and individual project offices; and providing information about foreign debt servicing to the superintendent of public debt, Central Bank of Sri Lanka (CBSL).

¹ Department of External Resources website. www.erd.gov.lk/.

- (viii) Arranging local bank financing for development projects in line with the government's Economic Policy Statement.
- (ix) Facilitating the preparation of the government's annual budget for each foreign-funded development project.

Department of National Planning

The DNP ensures that policies, action plans, programs, and projects formulated and implemented by various government agencies are within the bounds of the National Development Policy Framework and the medium-term macroeconomic policy framework. The DNP has the following key functions:²

- (i) Preparing long- and medium-term development plans and the Public Investment Program.
- (ii) Assisting line ministries and agencies in preparing sectoral plans, programs, and projects.
- (iii) Developing the macroeconomic policy framework and strategies.
- (iv) Reviewing economic development policies, strategies, and programs.
- (v) Appraising project proposals submitted by line ministries and agencies.
- (vi) Providing technical input in capital budget preparation.
- (vii) Preparing and updating the project pipeline.

Department of Project Management and Monitoring

The Department of Project Management and Monitoring monitors and evaluates the development projects and programs of the government, including projects funded by foreign development partners. The department obtains annual activity plans for the various projects from the respective executing agencies and reviews their progress (both major activities and financial progress) every quarter. Issues identified during the monitoring are discussed with the relevant ministries, development partners, and project staff for resolution. All steering committees for donor-funded projects include a representative of the government. The department also holds midyear meetings with donors (including ADB) to review portfolio progress.

B. Ministry of Finance

The finance minister is empowered to arrange for the effectiveness of loan agreements signed with donors. According to the Foreign Loan Act (No. 29 of 1957 and amended under Act No. 23 of 1980), the President or any person specifically authorized by the President is empowered to sign agreements relating to foreign loans on behalf of the government. A Cabinet paper submitted to the President requests authorization for the signing of loan agreements by the secretary to the Treasury, and an authorization letter is obtained from the President for each loan agreement to be signed.

² Department of National Planning. 2011. *Annual Performance Report 2010*. Colombo.

Department of National Budget

The Department of National Budget (DNB) is responsible for preparing the national budget and having it approved by the legislature. The budget estimates submitted to the legislature show the sources of funding, including foreign funds. The DNB scrutinizes the budget estimates, including the estimates for foreign-funded projects received from the ERD and the line ministries, and incorporates these into the state budget after discussing them with the ERD and the Department of Treasury Operations (TOD). The budget estimates for the foreign and local expenditures of the provincial councils, as recommended by the Finance Commission, are also included in the budget. The key functions of the DNB are as follows:³

- (i) Formulating annual budget estimates for ministries, departments, and statutory agencies of the government in consultation with spending agencies.
- (ii) Issuing budget circulars and guidelines.
- (iii) Enforcing appropriate budgetary management measures to ensure that funds are used exclusively for the declared purposes and within the approved limits.
- (iv) Ensuring the effectiveness of government spending by coordinating with the spending agencies.
- (v) Analyzing expenditure to monitor financial and physical progress.
- (vi) Preparing Observations on Cabinet Memoranda related to public expenditure management.
- (vii) Continuously reviewing progress in the implementation of budget proposals.

Department of Treasury Operations

The TOD handles matters relating to the management of the consolidated fund and the public debt. TOD translates the revenue and expenditure estimates in the national budget into operating cash inflows and outflows, to effectively meet and manage the budget targets of the government. Key functions of the TOD are as follows:⁴

- (i) Managing the Treasury cash flow.
- (ii) Facilitating domestic and foreign commercial borrowings.
- (iii) Disbursing Treasury funds through the payment system.
- (iv) Assessing and prioritizing the spending needs of government agencies, and releasing funds to meet those needs.
- (v) Issuing Treasury guarantees.
- (vi) Generating funds flow relating to the onlending programs of the government.
- (vii) Estimating, collecting, and accounting for nontax revenue under 10 revenue heads.
- (viii) Facilitating the disbursement of funds under foreign aid loans and grants.
- (ix) Accounting for government borrowings and debt repayments.
- (x) Authorizing and supervising government bank accounts and advance⁵ accounts.
- (xi) Facilitating accounting for foreign-funded projects.

³ Department of National Budget website. www.treasury.gov.lk/web/department-of-national-budget.

⁴ Department of Treasury Operations. 2014. *Annual Performance Report 2013*. Colombo.

⁵ Formerly called “imprest” account.

Department of State Accounts

Key functions of the Department of State Accounts (DSA) are the following:⁶

- (i) Operating a centralized accounting system to record the financial transactions of government institutions other than provincial councils and local authorities, and publishing the quarterly and yearly national accounts.
- (ii) Implementing computer-based accounting systems in all government institutions, preparing accounts, and providing improved management information systems based on the data and having the systems updated to meet changing needs.
- (iii) Maintaining accounting and financial analysis systems for the effective use of foreign aid and for public debt accounting.
- (iv) Continuously reviewing and upgrading public sector accounting systems, issuing instructions and guidelines to maintain the systems and procedures in accordance with accepted standards, and providing training for accounting staff.
- (v) Providing revenue and expenditure information to the auditor general, the central bank, the International Monetary Fund, ADB, and similar institutions.
- (vi) Assisting the ministries and departments in migrating from cash to accrual accounting, which requires additional disclosures in the accounts. For example, since 2013, land and buildings have been valued and brought into the accounts of ministries, departments, and agencies. The DSA director general is also a member of the Public Sector Accounting Standards Committee formed under the Institute of Chartered Accountants of Sri Lanka (ICASL) to formulate and publish the Sri Lanka Public Sector Accounting Standards (SLPSAS).

Department of Public Finance

The Department of Public Finance is responsible for strengthening the governance environment within which the public sector operates. It ensures that a sound regulatory framework exists for public finance, to improve transparency, accountability, and service delivery in the public sector. This department formulates and updates the Financial Regulations and the Government Procurement Guidelines, the two key procedure manuals adopted for public finance. These procedures also govern the use of foreign funds and accounting for such funds:⁷

- (i) Formulating, developing, promoting, reviewing, and implementing policies, procedures, and practices in public financial management (Financial Regulations, public procurement management, asset management).
- (ii) Assisting the Committee on Public Accounts (COPA) in its examination of government agencies, and taking follow-up actions to implement the committee's recommendations, including issuing Treasury minutes.
- (iii) Managing public assets and monitoring the effectiveness and efficiency with which these assets are used.
- (iv) Ascertaining uniformity in the treatment of government receipts and creating a continuous control mechanism under the Financial Regulations relating to government revenue.

⁶ Department of State Accounts website. www.treasury.gov.lk/web/department-of-state-accounts.

⁷ Department of Public Finance website. www.treasury.gov.lk/web/department-of-public-finance.

- (v) Reviewing departmental fees and charges and proposing revisions when necessary.
- (vi) Reviewing and monitoring the operation of funds under the various ministries and departments.
- (vii) Scrutinizing requests for write-offs and waivers in relation to Financial Regulations No. 104 and No. 113.
- (viii) Implementing government procurement strategies to create the necessary framework for the procurement of goods, works, and consulting services that will ensure value for money, open and effective competition, ethical conduct and fair dealing, and transparency and accountability in public procurement.
- (ix) Assisting the minister of finance and planning in formulating government policies that conform to the government's financial vision.
- (x) Taking appropriate follow-up action to address issues raised in the auditor general's reports.

Department of Management Audit

The Department of Management Audit (DMA) is the national level management audit partner to the Ministry of Finance (MoF). It helps make the management audit of the public sector more effective, mainly by strengthening the audit and management committees as Treasury representative; assisting the top management in overseeing the internal controls and the management audit functions of the ministries, departments, and projects; sustaining the management audit process by communicating the management audit guidelines, standards, and practices; and coordinating and conducting continuing professional development programs for internal auditors. It also carries out special investigations to disclose irregularities in the public sector, and recommends and introduces preventive measures to keep such irregularities from occurring.

C. Finance Commission

The Finance Commission was established under the 13th Amendment to the Constitution to facilitate the transfer of funds to the provinces. The Finance Commission is the intermediary between the central government and provincial councils in financial matters. The “needs of the provinces” under province-specific development grants (PSDGs), criteria-based grants (CBGs), block grants and revenue performance grants (RPG) are determined in the provincial annual action plan. Each year, the Finance Commission recommends to the President, and negotiates with the MoF, the annual provincial allocations. Estimates of foreign funded capital flows to provinces for provincial projects or entities, which are prepared as soon as the projects and entities are identified, are considered when allocating funds to provinces.

D. Central Bank of Sri Lanka

One of four key functions of the CBSL is managing the country's public debt, on behalf of the government. All advance accounts related to foreign funds are opened and maintained at the CBSL.

Public Debt Department

The Public Debt Department (PDD) raises, services, and manages public debt, including foreign commercial debt; operates the Scripless Securities Settlement System; and maintains the Central Depository System for Government Securities.⁸ After the ERD confirms the signing of a foreign loan agreement, the PDD maintains the details necessary for debt servicing. The PDD instructs the relevant departments in the CBSL to make the relevant payments based on the donor invoices submitted by the ERD for debt servicing. The PDD shares periodic debt servicing forecasts with the ERD and the International Operations Department, and provides the annual debt service forecast included in the national budget.

International Operations Department

This department manages the foreign exchange reserves of the CBSL. In relation to debt servicing, the department makes foreign currency available and pays the amounts owed based on the payment forecasts from the PDD.

E. Auditor General's Department

The auditor general is mandated under article 154 of the Constitution to audit public sector institutions, including all departments of the government, offices of Cabinet ministers, the Judicial Service Commission, the Public Service Commission, the Office of the Parliamentary Commissioner for Administration, and the Office of the Secretary General of Parliament. The auditor general also audits the Election Commission, provincial councils and local authorities, public corporations, businesses, and other undertakings vested in the government under any written law.⁹ The 19th Amendment to the Constitution, approved in Parliament on 28 April 2015, broadens the mandate by including companies registered under the Companies Act in which at least 50% of the shares are held by the government or a public corporation or local authority.

The Auditor General's Department practices its own financial audit methodology, which complies with the Sri Lanka Accounting and Auditing Standards Act No. 15 of 1995, and is consistent with the International Standards of Supreme Audit Institutions, issued by the International Organization of Supreme Audit Institutions. Article 154(6) of the Constitution requires the auditor general to report the audit findings to Parliament.

The auditor general likewise audits the financial reports of externally funded projects where the project financing flows through the National Treasury. Donor-funded projects, including those supported by ADB, are part of annual audit plans. Audit guidelines are provided to audit officials, and audit reports are submitted to the line ministries overseeing project implementation.

⁸ Central Bank of Sri Lanka website. www.cbsl.gov.lk/.

⁹ Auditor General's Department website. www.auditorgeneral.gov.lk/.

F. Asian Development Bank

Controller's Department, Loan Administration Division

The Controller's Department, Loan Administration Division (CTLA) of ADB authorizes all loans, grants, and technical assistance disbursements. It maintains ADB's accounting policies and systems, and is also responsible for billing, collection, and accounting of loan service payments.

Sri Lanka Resident Mission

Most of the processing of disbursements for ADB-funded projects (except cofinancing projects) is delegated by CTLA to the Sri Lanka Resident Mission (SLRM) disbursement unit. The unit processes withdrawal applications received from executing agencies or project management units (PMUs), using direct payment, reimbursement, and advance fund procedures.

III. Budgeting

A. Project Finance System

Under the Foreign Loans Act No. 29 of 1957 (as amended), the government may contract foreign loans and issue guarantees relating to foreign loans to public corporations and public enterprises. All foreign loan agreements entered into, and guarantees given, by the government must be signed by the President or a specifically authorized representative. All sums payable under those agreements and guarantees are charged to the Consolidated Fund. Loan and grant agreements with foreign donors, including ADB, are signed by the secretary of the Treasury on behalf of the government.

All government spending programs, including donor-funded projects, must be included in the central budget and have proper clearance from the DNP and the Cabinet of Ministers. The government's Financial Regulation No. 3 requires a two-stage approval process for project plans (Figure 1).

Figure 1: Project Planning Stages Based on Government Financial Regulations

Source: Authors' compilation based on the government's Financial Regulations.

Each project proposal, which must be based on an assessment of needs and conform to sector and national development strategies, is submitted to the DNP for preliminary feasibility evaluation. The DNP then conducts a detailed analysis of the proposal in consultation with the relevant line ministry. Preliminary and final approval by the Cabinet is required before the project is included in the national budget. Once the prefeasibility report is approved by the Cabinet, the project owners and the sponsoring ministry prepare the feasibility report and have it reviewed by the DNP before the Cabinet of Ministers grants final approval.

Under Ministry of Finance Circular No. MoF/ERD/2011/1 of 21 April 2011 (Streamlining Mobilization of Foreign Resources) issued to development partners, government spending programs must be properly recognized and approved by the DNP and the Cabinet before funding sources are sought. The ERD is the government agency responsible for obtaining foreign assistance for development projects recommended by DNP; no other agency is authorized to deal directly with foreign donor agencies. The ERD channels potential projects into the lending pipeline of the various lending agencies during the annual consultations between the government and donors.

Ministry of Finance Circular No. MoF/ERD/2014/1 of 26 June 2014 (Acceptance of Donor Assistance), notes that the assessment of foreign funding proposals for development projects is based not only on the financial terms but also on the expected use of the funds and the return on investment. Foreign funding is to be mobilized mainly for large-scale strategic infrastructure development projects, particularly in energy, roads and highways, ports and aviation, and irrigation and water supply, to increase the return on investment. On the other hand, official development assistance on concessionary terms will continue to be invested in soft sectors including health and education. Foreign funds are not to be used for projects where funds can be allocated from the Consolidated Fund and where local expertise is available.

The government may be either a recipient or a guarantor of foreign aid. If the government is the recipient, the central government provides subgrants to central or provincial government agencies or state enterprises, or onlends to state enterprises, depending on whether the investment capital can be fully recovered or can be recouped only partially. Subgrants may go to infrastructure development projects and social projects where the capital cannot be recovered, such as rural development, health, education, and public service projects. Partial subgrants and partial onlending may support projects where the capital can be partly recovered. For example, most infrastructure development projects in the water sector that are implemented with central government support have an onlending component. Loans generally make up a greater share of funding than grants in urban sector development projects, considering the greater capital recovery potential of such projects compared with development projects in the rural sector. Full recovery of investment capital favors onlending. The government is increasingly encouraging revenue-generating public corporations and boards (such as the Water Board and the Ceylon Electricity Board) to operate on a commercial basis. It is urging these entities to borrow on the strength of their balance sheet, with a government guarantee.

At the moment, all loan and grant agreements with ADB are signed by the government. But if ADB were to lend directly to public corporations and boards, it must consider the

fact that these entities are subject to the Finance Act No. 38 of 1971. Public corporations that have not adopted their own comprehensive financial rules and regulations must also comply with the government's Financial Regulations. ADB would need to consider this aspect if and when lending directly to public corporations.

The specific terms and conditions of onlending are discussed and agreed on during project preparation, appraisal, and approval, in light of government regulations and donor agreements. The project approval process is generally lengthy and time consuming.

B. Consolidated Fund

The Consolidated Fund, established under the Constitution, allows for unforeseen government expenditures, which require the submission of supplementary estimates to Parliament. Payments made under annual appropriation acts are sourced from the fund. The special statutory funds created under parliamentary statutes and not included in the national budget are other sources of government funds. Certain activities of government are financed through advance accounts. Appropriations made for advance account activities are distinct from the general appropriations and go into a separate fund for each activity.¹⁰ All transactions affecting foreign funds are recorded under the Consolidated Fund.

Government funds raised through taxes, imposts, rates, and duties, as well as all other government revenues and receipts not allocated for a specific purpose, all flow into the Consolidated Fund. The fund contains all monies belonging to the government that are not allocated to other funds, and monies of various ministries and departments, funds, and investments, including those in bank accounts. Foreign loans received by the government, including ADB loans, are held in individual or pooled bank accounts at the central bank in the name of the deputy secretary of the Treasury and forms part of the Consolidated Fund.

Government expenditures met through the Consolidated Fund require prior provision through an appropriation act or specific provision in the Constitution or other laws. Withdrawals from the Consolidated Fund must be covered by a warrant from the minister of finance and planning. The warrant is issued only for sums previously approved under a parliamentary resolution or under the law. The minister of finance and planning signs separate warrants for general services, special law services, and advance account activities, following parliamentary approval of the budget. The DNB then issues an annual circular to all spending agencies authorizing expenditure, and guidelines for public expenditure management.

The monies in the Consolidated Fund are managed by the TOD and kept at the CBSL or at two state banks, the Bank of Ceylon and the People's Bank. The provincial councils and local authorities maintain deposit accounts at local branches of the same two state banks.

¹⁰ General estimates are estimated revenues and expenditures to be charged against the Consolidated Fund for a particular year. The Consolidated Fund is a continuing fund and is not limited to a single year.

C. Budget Recording and Reporting

For several years, the government has been using a modified cash-based accounting system conforming to generally accepted accounting principles and practices, as defined by the Sri Lanka Accounting Standards (SLAS) and the International Public Sector Standards (IPSAS). In 2004, the government took steps to shift to accrual accounting, and in 2013, on a pilot basis, it instructed the various ministries and departments to prepare accrual-based annual accounts in addition to cash-based appropriation accounts. By the end of 2014, however, only around 15% of the institutions had complied. Modified cash-based accounting still prevails.

Under the modified cash-based accounting system, unspent budget allocations at the end of the financial year (31 December) are canceled and do not carry over into the next year. Exceptions to this rule, according to Financial Regulation No. 215(3b) and 215(3c), are: provision intended for the payment of grants or loans to statutory corporations and other institutions, if the sum is not immediately required by the corporation or institution; and committed expenditure under special circumstances based on the nature of expenditure, such as for shipment delays on import bills due for immediate payment after the end of the year. Funds for such expenses are reserved in the Treasury system, through an allocation to a special deposit account. These transfers should be indicated by means of footnotes in the appropriation account. An agency seeking such an allocation must send a request to the TOD through the secretary of the relevant line ministry, with justification for the payment to be made within the time schedule prescribed in a Treasury circular in 2015 (Closing of Accounts for the Financial Year 2015).¹¹ Allocations to the special deposit account will be made only after they are approved by the TOD director general, and must be used before the state accounts are finalized in February of the next year. Such allocations may also be made for donor-funded expenses if warranted by the nature and urgency of payment. These exceptions allowed for special payments make up only a very small proportion of total expenses.

D. Budget Process

Budget preparation in Sri Lanka derives its legal framework from the Constitution (articles 148–150), the annual appropriation act for the financial year, the Fiscal Management (Responsibility) Act No. 3 of 2003, applicable Financial Regulations, and other relevant circulars and guidelines issued by the Treasury.

Under the 13th Amendment to the Constitution (1987) and the Provincial Council Act No. 42 of 1987, part of the administrative decision-making authority and financial functions have been transferred from the central government to elected lower-level bodies. The 13th Amendment (9th Schedule) lists the powers transferred exclusively to the provincial councils (List 1: Provincial Council List), those retained by the central government (List 2: Reserved List), and subjects and functions where both the central government and the provincial councils are involved (List 3: Concurrent List).

¹¹ Department of State Accounts. 2015. *State Accounts Circular No. 244/2015: Closing of Accounts for the Financial Year 2015*. Colombo.

Sri Lanka has a three-tier administrative structure: central, provincial, and local government (Figure 2). The central government comprises a 225-seat Parliament, which has full control over public finances. There are nine provincial councils in the second tier, and 335 local authorities categorized into municipal councils, urban councils, and *pradeshiya sabhas* (legislative bodies for third-tier municipalities), in the third.

Figure 2: Administrative Structure of the Government of Sri Lanka

Source: Authors' compilation.

All activities of the government are predetermined and are set out in plans and programs. The annual estimates of expenditure detail the financial commitment of the government for the next year's program of activities. There are three budget areas—national, provincial, and local—corresponding to the three levels of government. The Constitution requires the central government to allocate adequate funds from the annual budget to the provincial councils to meet their needs. The Finance Commission is the intermediary between the central government and the provincial councils in finance matters. As a result of the devolution of power to local government under the 13th Amendment, all financial transfers to local authorities are channeled through the provincial councils and thereby come within the purview of the Finance Commission.

Central Budget

The DNB is responsible for preparing the national budget. In the budget, allocations are made to central government agencies and to provincial and local government expenditures that are within the mandate of the central government.

Each year, the DNB circulates a budget calendar to the spending agencies with a timeline for the formulation of the national budget process. Box 1 summarizes the steps involved in annual budget preparation.

For 2016, Budget Circular No. 03/2015 of 29 July 2015 instructed the spending agencies to take the zero-based budgeting approach to budget formulation, to improve efficiency and avoid duplication in the distribution of limited resources. The budgetary process is gradually moving toward performance-based budgeting approach. Zero-based budgeting approach was adopted in 2016 and 2017 to ensure that an orderly transition toward the performance-based budgeting is achieved in the medium-term. DNB Circular No. 2/2017 provides guidelines, and calls for budgets for the fiscal year 2018 to be formulated based on the performance-based budgeting approach.

Box 1: Annual National Budget Calendar

DNB = Department of National Budget.

Source: Authors' compilation based on Ministry of Finance and Planning. 2011. *A Guide: The Budget Process*. Colombo.

The budget estimates presented yearly to Parliament for approval are grouped into administrative, economic, and functional categories. Allocations are classified into a six-tier hierarchy, as follows:

- (i) Sectors (numbering 8) representing expenditure on the various functions of the government, namely, public services, national security and law enforcement, social security, human resources, infrastructure, real economy, environment, and finance.
- (ii) Head numbers (from 1 to 332) assigned to the major spending agencies. The spending agencies grouped under the eight sectors above are classified as follows:
 - (a) special spending units (departments, agencies, and commissions not classified under a specific ministry);
 - (b) ministries; and
 - (c) departments, including provincial councils, district secretariats, and certain institutions.
- (iii) Program codes (1 and 2) assigned to distinguish between operating activities and developmental activities.
- (iv) Project and subproject codes assigned to cost centers responsible for incurring expenditure (498 projects and 1,616 subprojects).
- (v) Category and object codes representing the economic classification of expenditure (14 categories and 51 object codes).
- (vi) Financing code representing the source of funding (domestic or foreign).

Government revenue sources are classified into tax revenue, nontax revenue, provincial council revenue, and grants. Tax, nontax, and provincial council revenue is presented in detail in the estimates. Foreign grants, on the other hand, are included in summary form under nontax revenue.

The expenditure estimates show the expected composition of national-level financing from domestic and foreign sources.

Funds sourced domestically are categorized as

- (i) domestic funds,
- (ii) foreign fund-related domestic funds,¹² or
- (iii) funds allocated through special laws.

Foreign funds classified according to funding source can take the following forms:

- (i) foreign loans,
- (ii) foreign grants,
- (iii) reimbursable foreign loans,
- (iv) reimbursable foreign grants,¹³ or
- (v) counterpart funds.¹⁴

¹² Including the cost associated with obtaining foreign aid.

¹³ This category pertains to project costs incurred by the government, which are later reimbursed by the donor according to the grant agreement.

¹⁴ Counterpart funds specifically refer to the rupee equivalent value of the imports under program or commodity aid credited to the government counterpart fund account in the central bank (e.g., imports related to the World Food Programme).

The budget states the funding sources for total expenditure in summary form. It also gives a summary breakdown of total funding by domestic and foreign sources for each ministry.

Individual foreign loans are detailed under the statement of estimated and actual borrowings in the final budget position report, which must be tabled in Parliament under the Fiscal Management (Responsibility) Act No. 3 of 2003.

The use of foreign funds according to Financial Regulations No. 620 and No. 621 requires including financial provision for all foreign-funded projects in the annual budget estimates of the central government. Financial Regulation No. 621 stipulates that no foreign funds are to be used unless and until provision has been made for them either in the annual estimates or by means of supplementary estimates or by virement procedure. Such provision should be made only for external projects that have been approved by the government. Provision for approved projects is made under the relevant ministry or department and included separately under capital and recurrent expenditure, showing the appropriate object class.

For foreign-funded projects where the executing agency is a central government agency, the budget for each project should be included under the annual appropriations of the relevant central government ministry under which the project is to be implemented. If the executing agency is an agency under a provincial council or a local authority, the government applies a subgrant mechanism, the budget is made part of the central government budget under the Ministry of Local Government and Provincial Councils (MLGPC), and project expenditure is included in provincial local budgets. For projects that are implemented by both the central and provincial governments (e.g., roads, health, education projects), the expenditure allocated to the province is budgeted under the MLGPC and expenditure by the central government is included under the relevant line ministry. These amounts are taken into account in the annual financial statement of the relevant provincial council (budget of the provincial council), which is approved by the relevant local authority.

For projects implemented through state enterprises, grants and loans are captured under the relevant line ministry in charge of such corporations Financial Regulation No. 623, while guarantees are off-budget items and are treated as contingent liabilities. However, section 16 of the Finance Act allows public corporations to borrow funds domestically or abroad, with the approval of the appropriate minister and the minister of finance and planning. Foreign exchange borrowings must also have the prior consent of the minister of finance and planning.

In practice, projected expenditure for new projects is included in the budget only for those projects that are at an advanced stage of preparation. During project preparation, the ERD, the DNB, and other relevant government departments are involved in discussions from the start. These departments are therefore aware of the projects in the pipeline and their estimated budgets from the outset. As for ongoing projects, annual budget estimates are prepared by each PMU at the line ministry and forwarded to MoF through the ministry. The ERD and the DNB discuss the projected expenditure to be included in the budget with the line ministries.

Provincial and Local Budgets

For provincial councils, the chief secretary is responsible for financial management, and the provincial treasury is under the deputy chief secretary for finance. The budget is referred to as the annual financial statement and has to be approved by the provincial governor.

Provincial budgets have income and expenditure sections. Under section 19 of the Provincial Council Act No. 42 of 1987, the main sources of funds of the provinces are grants provided by the government, provincial revenue transfers collected by the central government authorities, and revenue collected at the provincial level for devolved subjects. In 2016, zero based budgeting was introduced to ensure that public resources are used efficiently and effectively. Guidelines for the preparation of estimates based on zero based budgeting method were provided under DNB Circular No. 03/2015. With 2 years of experience in implementing zero-based budgeting, the budgetary process is gradually moving toward performance-based budgeting approach. DNB Circular No. 2/2017 provides guidelines, and calls for budgets for the fiscal year 2018 to be based on the performance-based budgeting approach.

Under Financial Regulation No. 16, any provision made at the national level for other levels of government must be in the form of grants or contributions. Also, such provision must be made in the national budget under the MLGPC. The Finance Commission is responsible for facilitating fund allocations from the central government to provincial councils. An annual needs assessment is a prerequisite for allocating and apportioning funds for the capital and recurrent expenditures of provincial councils. Since financial transfers to local authorities are also channeled through provincial councils, local government expenditure is included in the provincial needs assessment. Funds for provincial councils are transferred through the General Treasury as recommended by the Finance Commission, and come in four forms: block grants, criteria-based grants (CBGs), province-specific development grants (PSDGs) and revenue performance grants (RPG). Block grants are for recurrent expenditure, while CBGs, RPGs, and PSDGs are for capital expenditure. The 13th Amendment to the Constitution provides a reserved list of external financing resources for the exclusive use of the central government. Foreign loans are included in the Reserved List under the heading “finance in relation to national revenue, monetary policy and external resources; customs, and hence are exclusively under the authority of the central government.”

CBGs and PSDGs are mainly intended to help reduce regional disparities. CBGs are for activities specified in the broad guidelines of the Finance Commission for which each provincial council has the discretion to allocate such grants to relevant sectors within a province. The use of PSDGs, on the other hand, is based on the project proposals in the provincial annual development plan submitted to the Finance Commission, which allocates these PSDGs to specific sectors within a province. The Finance Commission recommends a new grant called revenue performance grants (RPGs) in order to encourage provincial revenue generation. This is a development oriented grant, pivoted on incremental devolved revenue collection. The provinces will have discretionary power to utilize this grant for capital related programs. The provincial councils are given guidelines or procedures they should follow when using these grants. For example, the Finance Commission Circular FC/PSDG and the CBG/Circular/2011/1 detail the points to be considered. Grants for specific projects usually consist of donor funds that are routed through the government setup.

Guidelines provided by the Finance Commission require provincial councils to submit needs assessments.

In practice, the Finance Commission holds discussions with each provincial council on its annual needs, taking into account the government's development strategies, as well as the previous allocation and its use. The Finance Commission then recommends to the central government the amount required by all provincial councils, and negotiates the annual bulk allocation with the DNB. The allocated amount will be apportioned according to a statistically determined formula based on the original amount submitted. The actual transfers made to provincial councils by the central government for capital expenditure CBGs and PSDGs would be less than the amount allocated in the central budget. This discrepancy could have an impact on the implementation of donor-funded projects where the provincial council is significantly dependent on budgetary allocations for counterpart funds.

Provincial expenditure consists of recurrent expenditure to meet salaries and other recurrent expenditure, and capital expenditure for investment in socioeconomic development. Each month, all provincial councils report to the MLGPC their actual expenditure on block grants, CBGs, PSDGs, and other donor funds, and send a copy of the report to the Finance Commission. The actual expenditure of provincial councils is not incorporated in the annual financial statements of the central government. Instead, the entire amount transferred as grants to provincial councils is treated as expenditure. For this reason, and given the fact that provincial councils are independent bodies that have no direct responsibility for reporting their expenditure to the central government, it is important for donors to have their own mechanisms for monitoring actual expenditure at the provincial level. Expenditure under foreign-funded projects is captured in provincial accounts, and all provincial council accounts are subject to audit by the auditor general.

Budget preparation by provincial councils and local authorities is primarily guided by the central budget calendar. Box 2 summarizes the stages in the provincial and local budget cycle.

E. Budgetary Channels

Relationship between Disbursement and Budget Plans

Project owners prepare an annual disbursement plan and submit it to Department of Treasury Operations (TOD). In addition, monthly cash requirements for reimbursable foreign aid are presented to the TOD (through advance accounts) indicating the due dates for the release of funds. The TOD generally releases funds in several tranches on the basis of the due dates and the amount required during the month.

For provincial projects, the provincial treasury receives funds according to donor agreements and budget allocations made under the MLGPC. Provincial councils also submit each month their reimbursable foreign aid requirements to the TOD through the MLGPC.

Box 2: Annual Budget Calendar for Provincial Councils and Local Authorities

Source: Authors' compilation based on One-Text Initiative, 2012. National Budget Making and Fiscal Devolution in Sri Lanka. Colombo.

Accounting for Foreign Funds

The Department of State Accounts (DSA) is responsible for budgetary accounting. Foreign funds disbursed through the central budget are accounted for in Treasury books according to funding source identified under the financing categories in Financial Regulation No. 621. Accounting officers are required to keep details of foreign aid expenditure according to finance code, and to report expenditure on foreign aid projects to the DSA through monthly summaries of accounts or transfer orders. In practice, the executing agency submits a monthly summary of expenditure to the relevant line ministry or department,

indicating the aggregate project expenditure according to the object code in the national budget. The ministry or department brings all these details together in its own monthly summary of accounts, which is submitted to the Treasury.

As for onlending to public corporations or statutory boards, the secretary of the ministry under which it is budgeted must take adequate steps to ensure repayment of capital and interest. The borrowing institution must pay interest to the TOD according to the agreed rate in the subsidiary agreement, for the balance to be withdrawn from the loan account. The loan amount must also be settled according to the terms and repayment schedule in the subsidiary agreement. Generally, under the agreement, any delay in the payment of the loan amount or interest results in the imposition of a demurrage. These payments are made to the account of the deputy secretary of the Treasury.

The TOD and the ERD are tasked with monitoring all loans and guarantees given to public enterprises.

F. Internal Controls

Expenditure Controls

Chapter XVII of the Constitution gives Parliament full control over public funds in Sri Lanka. Government expenditure requires prior provision through an appropriation act or a specific provision in the Constitution or other law. Government Financial Regulations and circulars issued by the MoF are comprehensive with respect to internal controls and are generally observed.

The minister of finance and planning has overall responsibility for supervising public finance administration in the country. Expenditure control occurs at many levels of government—at the ministry level, through the chief accounting officer; at the department level, through the accounting officer; and at the spending unit level, through the accountant. Within an institution, there is also expenditure control through segregation of duties. These expenditures are subject to scrutiny by internal and external auditors. Another way in which Parliament exerts control over expenditure is through legislative committees, namely, the Committee on Public Accounts (COPA) and the Committee on Public Enterprises (COPE), which examine external audit reports. COPA oversees the ministries and departments, including government revenue collection agencies, while COPE oversees all public corporations, government-owned companies, trust funds, and special statutory funds. After considering the report of the auditor general, these two committees call on responsible institutions and officers to answer to the House for the issues highlighted in the reports.

With regard to foreign funding, another level of control is also brought in through compliance with financing agreements and donor financing mechanisms.

Internal Audit

Financial Regulation 133 requires large departments, particularly those with sub-offices, workshops, stores, etc., and departments engaged in development work, to establish

internal audit units. In case of smaller departments, if there is an internal audit unit attached to the ministry concerned, its scope may be extended to cover smaller departments, ministries, departments, and agencies. The Department of Management Audit (DMA) under the MoF has issued several circulars to guide internal audit. With regard to the internal audit of projects, the DMA has indicated that it is advisable for the internal audit units of ministries and departments to include all projects implemented under the respective ministries or departments in their annual internal audit plan. DMA Circular No. 5 (Guidelines for Internal Audit to Projects Funded by Foreign or Local Funds) sets out guidelines for internal auditors of ministries and departments in identifying important auditable aspects of a project and relevant documents and circulars to be reviewed, and includes a questionnaire based on Financial Regulations and circular instructions relevant to the use of foreign funds.

The main project activities that an internal auditor should pay particular attention to are listed in Box 3.¹⁵

Box 3: Main Focus of Internal Audit

Monitor whether the project is being implemented according to the agreed work plan, or if any problem has been encountered in its implementation

Monitor whether the required project staff and other facilities are being provided
Implement controls to ensure that technical specifications are complied with
Supervise consultants to ensure compliance with responsibilities

Ensure that procurements conform to the requirements of the government and the donor
Ensure that disbursement procedures agreed on with the donor are being complied with and guidelines relating to the withdrawal of funds are being followed

Ensure the construction of civil works, the installation of equipment, and the supply of other goods and services are in accordance with accepted standards and the contract agreement
Ensure the availability of budgetary provision and sufficient liquidity

Ensure compliance with agreed conditions and covenants in the financing agreement
Ensure that the government assurances and obligations are being fulfilled
Oversee the reallocation among the project categories and components, and determine whether there is a need for additional funds

Oversee changes in scope and additional work

Determine extension of the project period

Ensure compliance with commissioning procedures; categories of operation and maintenance; instructions and completion of administrative requirements such as issuance of completion certificates, warranty certificates, insurance and claims releases, and handing over of assets, etc.

Source: Department of Management Audit. 2010. Guidelines for Internal Audit of Projects Funded by Foreign or Local Funds. *DMA Circular No. 5*. Colombo.

¹⁵ Department of Management Audit. Circular No. 5 (Reference No. DMA/ADM/2010-80). Colombo.

Financial Regulation 134 requires internal audit programs for ministries and departments that enable systematic, adequate, and efficient checking of the work done. Internal audit reports related to financial operations must be furnished to the auditor general. In practice, the internal audit units of ministries and departments prepare annual audit plans that are reviewed and approved by the DMA. Although regulations provide for and encourage the conduct of internal audits of all projects, internal audit units conduct project audits selectively, on the basis of available capacity. A DMA review of project internal audit operations in 17 ministries indicated that out of a total of 151 projects reported by these ministries, only 56 projects were included in their internal audit plans for 2014. Of the 56 projects, only 33 underwent at least one internal audit that year; no progress reports for the rest were forwarded to the DMA.

Internal audit at the provincial level is carried out by the internal audit department in each province. The department is headed by a provincial audit director reporting to the chief secretary of the province. An internal audit program for the financial year is prepared annually and approved by the chief secretary. This is forwarded to the auditor general, and a copy is sent to the governor of the province. The department also produces quarterly reports on audit queries, which are submitted to the governor, with copies sent to the auditor general and the chief secretary.¹⁶

Segregation of Duties

The regulations also provide for financial control through delegation of authority, where an accounting officer may delegate functions generally or for an identified transaction in a reasonable way, ensuring adequate segregation of duties for sound internal control, also taking into account the workload within the officer's purview and without contradicting the applicable Financial Regulations. The accounting officer will, however, remain responsible for the arrangement related to delegation and for the supervision of the system of financial control in general. The officer to whom a function is delegated will have full discretion in performing the attendant activities while being held accountable for them. For expenditure control, it is important to distinguish the following stages or functions, and to delegate authority for each stage to individual officers: authorization, approval, certification, and payment.

Financial Regulation Nos. 136–139 detail the responsibilities of delegated officers related to the above functions. However, in particular circumstances, such as where resource limitations exist, the involvement of an officer in more than one of the above functions could increase the risk of error, malpractice, or fraudulent activity. This possibility should be considered during project appraisal.

Authorization and Approval

With regard to receipt of funds, once the loan takes effect, the executing agency submits to the ERD sufficient evidence of authority of the persons who will sign withdrawal applications for fund disbursements, which the ERD forwards to the donor along with

¹⁶ Department of Internal Audit websites. http://www.interauditdep.nw.gov.lk/interauditdep/index.php?option=com_content&view=article&id=5&Itemid=9&lang=en (for the North Western Province) and <http://www.cs.cp.gov.lk/en/about-us/chief-secretary-s-message/department-of-audit.html> (for the Central Province).

specimen signatures. Generally, the signatories appointed are the secretary of the line ministry, the chief accountant of the ministry, the project director, the project chief accountant, and project account. In practice, at least two signatories sign the withdrawal applications. If the PMU is created directly under a line ministry, both signatories could be from the PMU, with the project director being one of them. If the PMU is at the provincial level and budget allocations are made through the MLGPC, one signatory is either the secretary or the chief accountant of the ministry, while the other is the project director.

Reporting and Monitoring

Project management units have reporting responsibilities toward the relevant ministries, departments, and agencies they come under. Further, the PMUs or executing agencies have collective reporting responsibilities toward the government and the donors. Some of the main reporting responsibilities are the following:

- (i) Project owners to prepare an annual disbursement plan and submit it to the TOD and the donor.
- (ii) Project owners to prepare the monthly cash requirement for reimbursable foreign aid and submit it to the TOD (through advance application) indicating the due dates for the release of funds.
- (iii) Project owners to prepare statements related to foreign aid (monthly summary of expenditure statement, quarterly report on foreign-funded projects, monthly and annual returns of reimbursable foreign aid, etc.) and submit these to the relevant ministry. The ministry will collate these for each project and submit the collated statements quarterly and yearly to the ERD. The ministries will submit monthly expense summaries to the DSA through the Computerized Integrated Government Accounting System (CIGAS) on the basis of the government chart of accounts, which includes project expenditure.
- (iv) Project owners to prepare and submit annual financial statements to the relevant executing agency (ministry, department, or agency).
- (v) Executing agency to submit annual financial statements to external auditors (auditor general) and forward the audited financial statement to the donor.

Foreign-funded projects are monitored at different levels. Steering committees are created for development projects. The Department of Project Management and Monitoring is responsible for monitoring and evaluating development projects and is also a member of the project steering committee. It obtains the annual activity plan for each project from its executing agency and conducts quarterly reviews of progress. These projects also undergo internal and external audit to ensure that they are being implemented according to the agreed terms and conditions of the loan agreement and are complying with government rules and regulations.

IV. Onlending Arrangements

A. For Ministries, Departments, and Agencies

The Government of Sri Lanka borrows from foreign sources to fund development spending. Such foreign funds for all entities under the central government always take the form of subgrants, which must be budgeted under the respective budget heads and approved by Parliament. These entities are entitled to withdraw funds from the Consolidated Fund against those budget allocations. Although the central government borrows in foreign currency, the subgrants to ministries, departments, and agencies are in local currency.

B. For Provincial Councils

According to the Constitution, the provincial councils cannot borrow from foreign sources on their own. The central government always provides foreign funds to provincial councils in the form of local-currency subgrants. These subgrants to provincial councils are budgeted under either the MLGPC or the relevant line ministry. The subgrant funds are transferred to the provincial treasury according to the donor agreement, for withdrawal by the project owners against their provincial budget allocations.

C. For State Enterprises

Part of foreign funds (as decided by the government) are onlent or partially onlent to state enterprises in local currency. The conditions of the onlending are determined by the credit committee of the ERD during project appraisal and approval, and the subborrower's financial performance is assessed before approval. A separate subsidiary finance agreement incorporating the agreed conditions is signed by the secretary of the Treasury, or by the ERD director general and the director general of the state enterprise. Provisions must be made under the budget of the relevant line ministry for the foreign funds to be used by the state enterprise.

With regard to onlending to state enterprises, it is the responsibility of the secretary of the relevant line ministry to take adequate measures to ensure satisfactory repayment of capital and payment of applicable interest to the government for the balance withdrawn from the loan account. These loans to state enterprises are closely monitored by the TOD.

The government is now in discussions with the intent of encouraging state enterprises to borrow on their own from foreign sources, with government guarantees. Since the operations of state enterprises are commercial in nature, it is believed that these entities will be able to repay borrowings on their own. As the first step, in 2014 the government started converting all previous loans from the TOD to the water and energy sectors into government equity to strengthen the balance sheets of entities in the sector. At the moment, key entities with direct borrowings are the Civil Aviation Authority, the Ports Authority, the Ceylon Electricity Board, and the National Water Supply and Drainage Board, only the latter two of which have borrowed directly from domestic sources. The Civil Aviation Authority and the Ports Authority have borrowed directly from foreign sources.

V. Foreign Exchange and Interest Rate Risks

The foreign exchange and interest rate risks in the case of subgrants are borne by the central government. With respect to onlending, foreign exchange risk is borne by the central government at all times, as loans to subborrowers are always in local currency. The interest rate for the loan could, however, be transferred to the subborrower at the same rate or lower. In this case, the interest rate risk may be borne either by the subborrower or by the central government.

The payment of principal and interest and other charges on the due dates specified in the subsidiary finance agreement is the responsibility of subborrowers. Demurrage will have to be paid if the payment of the loan or interest is delayed. The TOD monitors disbursements related to onlending and collects loan principal and interest charges from subborrowers according to the agreement.

VI. Funds Flow Arrangements

As part of the prerequisites for withdrawals from loan account, the executing agency or the PMU submits to ADB evidence of authority of the persons who will sign the withdrawal applications or deliver the withdrawal applications electronically through the Client Portal for Disbursements system to ADB. ADB funds flow arrangements in Sri Lanka fall under four categories. Each of these categories is discussed below, with details of funds flow, recording in the government accounts, transfer of funds between government agencies, and documents required under each arrangement.¹⁷

A. Reimbursement Procedure

This funds flow method requires the executing agency or the PMU to provide bridge financing for the ADB portion of expenditure using its own resources. ADB reimburses the latter from the loan for the expenditure incurred, at the request of the executing agency or the PMU.

Funds Flow

The steps involved in reimbursement are as follows (see Figure 3):

Upon receipt of advance from the government

- (i) The PMU submits to the executing agency a withdrawal application based on the expenditure forecast for the next 6 months.
- (ii) The authorized official of the executing agency reviews and signs the withdrawal application and submits it along with the supporting documents (see Box 4) to the TOD. A copy is sent to the ERD for reference.
- (iii) The TOD checks the loan agreement and releases the requested funds if the budget allocations for these are in place. The funds are released to the executing agency's account, and then transferred to the PMU's account.

Upon receipt of payment of services and replenishment from government

- (i) The contractor, the supplier, or the consultant submits the invoice to the PMU.
- (ii) The PMU pays the contractor, the supplier, or the consultant from the advance funds received from the government.

¹⁷ In case of conflict between ADB's procedures described in this report and the procedures in ADB's guidelines (*Loan Disbursement Handbook 2015*, or as amended from time to time), the procedures in ADB's guidelines will prevail.

Figure 3: Reimbursement Procedure

ADB = Asian Development Bank, DST = deputy secretary for the Treasury's account, EA = executing agency, ERD = Department of External Resources, PMU = project management unit, SLRM = (ADB's) Sri Lanka Resident Mission, SOE = statement of expenditure, TOD = Department of Treasury Operations, WA = withdrawal application.

Source: Authors' compilation based on discussions with government stakeholders.

- (iii) Periodically, PMU prepares a withdrawal application to make up for the expenses incurred by the government. The withdrawal application is submitted to the executing agency for review and approval.
- (iv) The authorized official of the executing agency reviews and signs the withdrawal application and submits it along with the supporting documents (see Box 4) to the TOD. A copy is sent to the ERD for reference.
- (v) The TOD reviews the request documents and releases the funds to the executing agency's account, before they are transferred to the PMU's account.

Box 4: List of Required Documents for Reimbursement

For advances and replenishments from the government

- 1 Request letter to the executing agency for recommendation of monthly advance
- 2 Monthly advance application, recommended by the executing agency

For fund disbursement under reimbursement method

- 1 Evidence of payment
- 2 Invoice of contractor, supplier, consultant
Interim payment certificate or summary of work progress (for progress payment related to civil works)
Unconditional bank guarantee (only if relevant) OR
- 3 Statement of expenditures or certificates attesting to percentage of work completion and amount withdrawn (if simplified documentation is approved)

Source: ADB. 2017. *Loan Disbursement Handbook*. Manila.

Upon receipt of reimbursement from ADB

- (i) The executing agency or the PMU submits a withdrawal application in ADB's standard format along with the supporting documents (Box 4) to the Sri Lanka Resident Mission (SLRM). A copy is sent to the ERD for reference.
- (ii) The SLRM verifies the documents received, enters the details into ADB's system for ADB loan operations (the Loan Financial Information System), and generates a disbursement voucher if the withdrawal application is in order.
- (iii) After receiving notification from the Loan Financial Information System, the ADB Controller's Department authorizes the withdrawal.
- (iv) The ADB Treasury Department remits funds to the deputy secretary for the Treasury's account.

Financial Regulation 625(5) requires project owners to claim reimbursement monthly, to avoid using government funds while foreign aid is available. If a large-scale expense is incurred during the project, the Financial Regulation further emphasizes that the expense should be claimed promptly irrespective of the monthly claims. However, there are delays in the submission of claims by the executing agencies and PMUs, and the TOD has to issue reminders.

Recording in the Government Accounts

The executing agency accounts for the expenditure in the CIGAS. The TOD identifies the receipts of claims from ADB through the monthly bank statements and accounts for these by debiting the cash account and crediting a suspense account, which is known as the reimbursable foreign aid reconciliation account. The ERD updates the Commonwealth Secretariat Debt Management and Recording System (CSDRMS) with the ADB disbursement details obtained by logging on to ADB's Loan Financial Information System (LFIS), and sends the collated information monthly to the TOD through the ERD Monthly Bulletin. The TOD identifies the liabilities from the bulletin, accounts for these by debiting the reimbursable foreign aid reconciliation account and crediting the liability account, and submits the monthly summary to the DSA for collating the government accounts.

Documentary and Approval Requirements

The withdrawal application must be signed by two authorized signatories for the project. If the PMU is set up under a line ministry, the application does not have to be signed as well by an official at the ministry, as the project director and the PMU accountant already represent the line ministry.

Results-Based Lending Projects

The release of funds for results-based lending (RBL) projects also follows the reimbursement procedure. The government is required to use its own funds for activities toward meeting disbursement-linked indicators and to claim reimbursement from ADB after achieving those indicators.

The achievement of the disbursement-linked indicators is independently verified through the verification mechanism agreed on by the government and ADB. ADB then conducts a mission and signs an aide-mémoire, together with the MoF and the executing agency, stating that the indicators have been achieved. For a provincial project, the aide-mémoire will also be signed by the provincial project counterpart. For fund disbursements, the executing agency will submit certified copies of evidence documents along with the withdrawal application. On receiving the withdrawal application and the evidence documents, the project officer will certify that the desired results have been met and advise the Controller's Department, Loan Administration Division (CTLA) to disburse the funds.

Although ADB funds are disbursed on time, the country has experienced difficulties in disbursing sufficient government funds on time for projects, which in turn affect the implementation of the programs. The implementation of RBL projects is even more challenging, given the fact that the project activities depend completely on national budget allocations and loan tranches are received only after the indicators are achieved. When several disbursement-linked indicators (DLIs) are due in a year, disbursements will be based on the achievement of certain DLIs (even if not all of the DLIs are achieved during the year). For the two RBLs implemented in Sri Lanka, disbursements were made upon full achievement of the relevant DLIs.

B. Advance Fund Procedure

For the purpose of foreign funds and in line with the provisions laid down in the loan agreement, separate accounts are maintained for each loan agreement. The advance account at the CBSL is in foreign currency in the name of the deputy secretary of the Treasury receives funds from donors at CBSL. A sub-account is opened at domestic commercial banks to receive foreign funds from the CBSL special currency account (advance account) in Sri Lanka rupees for PMU expenses. A separate sub-account is maintained by each executing agency to receive counterpart funds.

Under the advance method of disbursement, ADB remits an advance to the advance account to cover ADB's share of eligible project expenditures and periodic requests for replenishment from the executing agency or the PMU.

Funds Flow

The steps involved in advance fund method are as follows (see also Figure 4):

Upon receipt of advance from ADB

- (i) The executing agency or the PMU submits a withdrawal application based on the expenditure forecast for the next 6 months and following ADB's standard format, along with the supporting documents (see Box 5) to the SLRM. A copy is sent to the ERD for reference.
- (ii) The SLRM verifies the documents received, enters the details into ADB's system for ADB loan operations (the LFIS), and generates a disbursement voucher if the withdrawal application is in order.
- (iii) After receiving the notification, the ADB Controller's Department authorizes the withdrawal.
- (iv) The ADB Treasury Department remits funds to the advance account at the CBSL.

Upon replenishment of sub-account

- (i) The executing agency or the PMU submits a withdrawal application to the TOD requesting the transfer of funds from the advance account to the sub-account. A copy of the application is sent to the ERD for reference.
- (ii) The TOD checks the loan agreement and advises the CBSL to release the requested funds.
- (iii) The CBSL remits the funds to the sub-account. TOD is informed of the remittance through the monthly bank statement.

Payments to contractors, suppliers, and consultants, and liquidations or replenishments from ADB

- (i) The contractor, the supplier, or the consultant submits the invoice to the executing agency or the PMU.

Box 5: Documents Required for Fund Disbursement under Advance Fund Procedure

1

For advances

Estimate of expenditures

2

For liquidations and replenishments

Advance account reconciliation statement

Bank statement

Summary sheet and proof of payment and supporting documents as required under direct payment method OR

3

SOE (if SOE procedure is approved)

Certificates of FAW (if FAW procedure is approved)

FAW = force account works, SOE = statement of expenditure.

Source: ADB. 2017. *Loan Disbursement Handbook*. Manila.

- (ii) The executing agency or the PMU pays the contractor, the supplier, or the consultant from the sub-account. If the TOD is to pay the contractor, the supplier, or the consultant directly, the executing agency or the PMU submits a withdrawal application to the TOD for the required amount and the TOD makes the payment from the advance account.
- (iii) Periodically, the executing agency or the PMU submits a withdrawal application along with the supporting documents (see Box 5) to the SLRM for liquidation or replenishment of expenses incurred.
- (iv) The SLRM verifies the documents received, enters the details into ADB's system for ADB loan operations (the LFIS), and generates a disbursement voucher if the withdrawal application is in order
- (v) After receiving the notification, the ADB Controller's Department authorizes the withdrawal.
- (vi) The ADB Treasury Department remits funds to the advance account at the CBSL. The TOD is informed of the remittance through the monthly bank statement.

Recording in the Government Accounts: Initial Advance from ADB

The ERD updates the CSDRMS with the ADB disbursement details (replenishments) obtained by logging on to ADB's LFIS. The TOD accounts for the receipts identified through monthly bank statements by debiting the cash account and crediting the interim (main ledger) account, which is a suspense account, and submitting the monthly summary to the DSA for collating the government accounts.

Replenishment of Sub-account

The TOD records the release of funds for sub-account replenishment in the CIGAS. For advances, the interim (main ledger) account is debited and the cash account, credited. In case of replenishment, the expense account is debited and the interim (main ledger) account is credited to account for the fund transfer.

Payments from Advance Account

The TOD records all payments made directly to contractors, suppliers, or consultants from the advance account as expenses in the account by debiting the expense account and crediting the cash account.

Figure 4: Advance Fund Procedure

ADB = Asian Development Bank, CBSL = Central Bank of Sri Lanka, EA = executing agency, ERD = Department of External Resources, PMU = project management unit, SLRM = Sri Lanka Resident Mission, SOE = statement of expenditure, TOD = Department of Treasury Operations, WA = withdrawal application.

Source: Authors' compilation based on discussions with government stakeholders.

Replenishment from ADB

The ERD updates the CSDRMS with the ADB disbursement details (replenishments) obtained by logging on to ADB's LFIS. The collated information is sent monthly to the TOD through the ERD Monthly Bulletin. The TOD identifies the liabilities from the bulletin, and the receipts from ADB through monthly bank statements. The TOD accounts for the receipts by debiting the cash account and crediting the interim (main ledger) account, and for liabilities by debiting the interim (main ledger) account and crediting the liability account. The TOD submits the monthly summary to the DSA for collating the government accounts.

Documentary and Approval Requirements

The withdrawal application must be signed by the authorized signatories for the project.

C. Direct Payment Procedure

The funds flow under this method takes place only between ADB and the contractor, the supplier, or the consultants. The executing agency or the PMU incurs the expense and requests ADB to make the fund transfer directly to the contractor, the supplier, or the consultant by withdrawing from the loan account.

Funds Flow

The steps involved in direct payment are as follows (see Figure 5):

- (i) The executing agency or the PMU receives an invoice for the expense from the contractor, the supplier, or the consultant.
- (ii) The executing agency or the PMU approves the invoice and submits a withdrawal application to the SLRM in ADB's standard format, along with the supporting documents (see Box 6). A copy is sent to ERD for reference.

Box 6: Documents Required for Fund Disbursement under Direct Payment Procedure

1	Invoice of contractor, supplier, or consultant
2	Interim payment certificate with summary of work progress (if it is for a progress payment related to civil works)
3	Unconditional bank guarantee (where payment of retention money is due past the loan closing date)

Note: For the interim payment certificate, if the project is being implemented at the provincial level, the central agency, the executing agency, or the project management unit shall obtain confirmation of work progress from the subproject coordinating unit.

Source: ADB. 2017. *Loan Disbursement Handbook*. Manila.

- (iii) The SLRM verifies the documents received, enters the details into ADB's system for ADB loan operations (the LFIS), and generates a disbursement voucher if the withdrawal application is in order. For cofinancing projects, the SLRM enters the withdrawal application into the document repository system for CTLA to process the payment.
- (iv) After receiving the notification from the LFIS, the ADB Controller's Department authorizes the withdrawal.

Figure 5: Direct Payment Procedure

ADB = Asian Development Bank, EA = executing agency, ERD = Department of External Resources, PMU = project management unit, SLRM = Sri Lanka Resident Mission, WA = withdrawal application.
 Source: Authors' compilation based on discussions with government stakeholders.

- (v) The ADB Treasury Department remits the funds to the account of the contractor, the supplier, or the consultant.

Recording in the Government Accounts

As the coordinator between the government and ADB, the ERD has authorized read-only access to the LFIS. The ERD updates the CSDRMS with the disbursement details obtained by logging on to the LFIS and sends the collated information monthly to the TOD through the ERD Monthly Bulletin. The TOD identifies the direct payments made by ADB from the bulletin and requests confirmation of the details from the executing agency of the PMU. On receiving the information, the TOD records the expense by debiting the expense account and crediting the liability account, and submits a monthly summary to the DSA for collating the government accounts.

Documentary and Approval Requirements

The withdrawal application must be signed by two authorized signatories for the project.

D. Commitment Procedure

Like the funds flow for direct payments, the funds flow under this method occurs only between ADB and the commercial bank of the supplier. The executing agency or the PMU obtains the supplier's services on the basis of a letter of credit issued to the supplier's bank and funded through an irrevocable commitment letter from ADB to the negotiating bank (the supplier's bank) for the payments to be made.

Funds Flow

The steps involved in the commitment procedure are as follows (see also Figure 6):

Opening of letter of credit and request for commitment letter

- (i) The executing agency or the PMU opens a letter of credit in favor of the supplier. The letter of credit will take effect only after ADB issues the commitment letter.
- (ii) The executing agency or the PMU submits to the SLRM an application for a commitment letter, in ADB's standard format, along with the supporting documents (see Box 7). A copy is sent to the ERD for reference.
- (iii) SLRM prescreens the commitment letter application received and enters the details into ADB's system for ADB loan operations (the LFIS).
- (iv) Upon receiving the notification from the LFIS, the ADB Controller's Department issues an irrevocable commitment letter to the negotiating bank if the documents are in order. A copy of the commitment letter is provided to the executing agency or the PMU. The letter of credit issued takes effect only after the commitment letter is issued by ADB.

Figure 6: Commitment Procedure

ADB = Asian Development Bank, EA = executing agency, ERD = Department of External Resources, LC = letter of credit, PMU = project management unit, SLRM = Sri Lanka Resident Mission, SOE = statement of expenditure, WA = withdrawal application.

Source: Authors' compilation based on discussions with government stakeholders.

Box 7: Documents Required for Issuance of Commitment Letter

1

Copy of the letter of credit of which the commitment letter of ADB is requested

Source: ADB. 2017. *Loan Disbursement Handbook*. Manila.

Receipt of goods and confirmation by the executing agency or project management unit

- (i) The supplier sends the shipping documents to the letter of credit-issuing bank through the negotiating bank.
- (ii) The executing agency or the project management unit (PMU) communicates its acceptance of the shipping documents to the issuing bank after verification.
- (iii) The executing agency or the PMU receives the shipped goods from the supplier and accepts these after inspection.

Payment to supplier

- (i) The issuing bank informs the negotiating bank of the required payments.
- (ii) The negotiating bank requests payment from ADB (for the payment made or due to be made to the supplier according to the terms of the letter of credit) through Society for Worldwide Interbank Financial Telecommunications (SWIFT).
- (iii) On receiving the SWIFT notification, CTLA prepares a disbursement voucher and authorizes the withdrawal.
- (iv) The ADB Treasury Department remits the funds to the negotiating bank.

Recording in the Government Accounts

The ERD updates the CSDRMS with the disbursement details obtained by logging on to the LFIS, and sends the collated information monthly to the TOD on a monthly basis through the ERD Monthly Bulletin. The TOD identifies the direct payments made by ADB and requests confirmation of the details from the PMU. On receiving confirmation, the TOD records the expense by debiting the expense account and crediting the liability account. The TOD submits a monthly summary to the DSA for collation of the government accounts.

Documentary and Approval Requirements

The withdrawal application must be signed by the authorized signatories for the project.

VII. Accounting and Reporting

A. Accounting Standards

Private Corporations and Enterprises

The Institute of Chartered Accountants Act (No. 23) of 1959 created the Institute of Chartered Accountants of Sri Lanka (ICASL) as the national professional accountancy body, empowered through its council to pass regulations related to matters that are required or authorized under the act. The Sri Lanka Accounting and Auditing Standards Act (No. 15) of 1995 authorized the ICASL to issue the Sri Lanka Accounting Standards (SLAS) and provided for the formation of the Accounting Standards Committee, under the ICASL. Financial reporting by all Sri Lankan companies must be in compliance with these standards, which are based on the corresponding International Financial Reporting Standards and International Accounting Standards.

Public Corporations and State-Owned Enterprises

As for the public sector, no law requires the preparation of financial statements of the government in accordance with the International Public Sector Accounting Standards (IPSAS). Public corporations selling goods or providing services are identified as “specified business enterprises” under the Sri Lanka Accounting and Auditing Standards Act, and are required to follow the SLAS.

Government Sector Units

Ministries, departments, and district secretariats must prepare annual appropriation accounts under the guidance of the DSA’s annual circular on appropriation accounts.¹⁸ In an effort to elevate public sector accounting, the ICASL over the last few years has launched several initiatives including the establishment of the Public Sector Accounting Standards Committee, with members drawn from the MoF. The committee, together with the MoF, has already published 10 Sri Lanka Public Sector Accounting Standards (SLPSAS), which apply to statutory boards and noncommercial public corporations that follow accrual-based accounting, and is developing 10 more standards. All 20 SLPSAS are in line with the corresponding IPSAS.

¹⁸ Department of State Accounts. 2015. Appropriation Accounts 2015. *Circular No. 245/2015*. Colombo.

The first-four accrual-based SLPSAS, published in 2009, were on

- (i) presentation of financial statements;
- (ii) cash flow statements;
- (iii) accounting policies, changes in accounting estimates and errors; and
- (iv) borrowing costs.

On 1 January 2011, these were made effective for statutory boards and noncommercial public corporations that follow accrual-based accounting, under Public Enterprises Department Circular No. PED 54/2010, SLPSAS published in 2009.

The six other SLPSAS, issued in 2012, were on

- (i) effects of changes in foreign exchange rates;
- (ii) events after the reporting date;
- (iii) property, plant, and equipment;
- (iv) provisions, contingent liabilities, and contingent assets;
- (v) inventories; and
- (vi) revenue from exchange transactions.

These were declared applicable to the same organizations from 1 January 2014 under Public Enterprises Department Circular No. 03/2013, the two volumes of the SLPSAS. The 10 standards that are being developed¹⁹ are on

- (i) revenue from non-exchange transactions;
- (ii) presentation of budget information in financial statements;
- (iii) leases;
- (iv) related party disclosure;
- (v) investment property;
- (vi) construction contracts;
- (vii) segment reporting;
- (viii) disclosure of information about the agriculture sector;
- (ix) employee benefits; and
- (x) intangible assets.

Although not legally required to do so, the government, since 2002, has been preparing its annual accounts increasingly in accordance with cash-basis IPSAS. The DSA is committed to the transition to full accrual accounting and reporting according to the accrual-based IPSAS, and has taken several steps toward that end, first in 2004 and through additional disclosures in 2005. Valuation of government-owned land and buildings, as part of the migration process, was 85% complete by the end of 2014, while asset recording on an accrual basis has been pilot-tested since 2013. The government computerized accounting system has also been further improved to enable the recording of asset data in financial statements from 2015 onward. However, the transformation is not yet complete. The state

¹⁹ ADB is providing consulting support for the development of these 10 SLPSAS.

accounts for 2014 were prepared on a modified cash basis, in accordance with generally accepted accounting principles and practices.

Besides preparing cash-based appropriation accounts, all ministries and departments have been instructed by the DSA to prepare accrual-based annual accounts from 2013 onward on a pilot basis, under SA/AS/AA Circular of 24 January 2013 (Preparation of Annual Accounts for 2013 under Accrual Basis), and to prepare financial statements, including balance sheets (statements of financial position), from 2014 onward under Circular GFS/02 of 24 June 2013 (Implementation of Accrual Accounting System). In line with the government's efforts to move toward accrual accounting, 36 ministries, departments, and agencies (around 15% of the total) submitted accrual-based annual accounts in 2014.

Circular GFS/02 lays out the steps to be followed in preparing the statement of income and expenditure as well as the statement of financial position under the accrual basis of accounting, and identifies the following additional journal entries to be recorded:

- (i) accounting for due arrears of revenue (debit due arrears of revenue account, credit relevant revenue account);
- (ii) accounting for accrued expenditure for recurrent or capital expenditure (debit relevant expenditure account, credit accrued expenditure account); and
- (iii) accounting for noncurrent assets (debit noncurrent assets account, credit noncurrent assets reserve fund).

B. Financial Regulations

The Financial Regulations (1992) of the government are binding on all ministries, departments, and statutory bodies, and on all state employees. They also apply to government corporations that have not adopted their own comprehensive financial rules and procedures. Any government corporation that intends to adopt its own financial rules and regulations, however, must receive prior approval for these from the MoF. In addition to the guidelines already issued by the Treasury, the Financial Regulations apply as well to divisional secretariats. These regulations apply to all government departments, irrespective of the fund from which activities are financed or to which remittances are made. Exceptions to this rule are funds that have been created under statutes, with specific rules and regulations applying to the funds of their activities, and funds that are exempted in whole or in part from the provisions of the Financial Regulations by virtue of specific authority granted by the secretary to the Treasury.

ADB funding for public corporations such as the Ceylon Electricity Board and the National Water Supply and Drainage Board, which have adopted their own financial rules and procedures, may be exempted from the Financial Regulations in whole or in part. However, as these entities are revenue-generating public corporations, they are subject to the SLAS, which comply with international standards. ADB projects with different public corporations may therefore be subject to different procedures, complicating fund disbursement verification and project monitoring.

From time to time, the government has initiated attempts to draft a public finance act to address perceived gaps in the basic legal framework for public finance management. Initiatives have also been taken to update the Financial Regulations, but these updated versions have not yet been published or adopted.

C. Application of Accounting Standards and Regulations

The application of accounting standards and regulations by government entities varies with the category to which an establishment belongs—ministry, department, or agency; nonrevenue-earning statutory body or public enterprise; or revenue-earning body or public enterprise. Ministries, departments, and agencies, as well as nonrevenue-earning statutory bodies and public enterprises must prepare cash-based budgets and financial statements, and report in accordance with the Financial Regulations (1992) and the Procurement Guidelines issued by the public finance department of the MoF. Under the Public Enterprises Department circulars mentioned above, nonrevenue-earning statutory bodies and public enterprises that follow accrual-based accounting (such as universities and local authorities) must now report in accordance with the SLPSAS.²⁰ Ministries and departments are also required to submit annual accounts based on accrual principles on a pilot basis.²¹ Commercial public corporations, on the other hand, adopt the SLAS like the private enterprises. Although no standards are set out in the Financial Regulations for foreign-funded projects, the Financial Regulations provide for the maintenance of project accounting records in accordance with accepted accounting principles, which require the adoption of accrual accounting procedures.

ADB-funded projects implemented through PMUs must therefore adopt accrual-based accounting principles under Financial Regulation No. 626 and State Accounting Circular No. 30/94 (Foreign Aid Accounting), while projects implemented through revenue-earning public enterprises must follow the SLAS. ADB's results-based lending (RBL) projects are implemented as part of ADB's government sector strategy through the national budget. ADB funding for RBL projects is based on the achievement of specified results and goes into the government's Consolidated Fund. These funds are accounted for in the ministries, departments, and agencies accounts of the relevant government agency in accordance with government Financial Regulations and circulars. For RBL projects, ADB has a built-in monitoring system for the components it funds. However, there may not be an overarching monitoring system for the entire program. As a result, while ADB may achieve the desired results from ADB-funded components, the overall government program may not achieve the desired results. The government could well consider strengthening the monitoring function for the entire program.

²⁰ Public Enterprises Department. 2010. Sri Lanka Public Sector Accounting Standards (SLPSAS). *Public Enterprises Department Circular No. PED/54/2010*. Colombo; Public Enterprises Department. 2013. *Sri Lanka Public Sector Accounting Standards (SLPSAS) Volumes I & II*. Public Enterprises Department Circular No. PED/03/2013. Colombo.

²¹ Department of State Accounts. *State Accounts Circular No. SA/AS/AA/Circular and GFS/02*. Colombo.

D. Accounting System

Basis of Accounting

Projects follow accounting and reporting systems based on accrual accounting procedures, under Financial Regulation 626 (1992) and DSA Circular No. 30/94 (Foreign Aid Accounting). These provisions are especially applicable to loan agreements with covenants requiring the submission to the donor of audited annual financial statements for the projects, as is the case with ADB-funded projects. PMUs of ADB projects at ministries, departments, agencies, statutory bodies, or public enterprises, thus use accrual-based accounting.

Accounting Documents

PMUs and implementing agencies must maintain proper accounting documents for their transactions. DSA Circular No. 2002/149 of 27 June 2002 (Guidelines and Procedures and Monitoring Systems on the Use of Asian Development Bank's Imprest Fund Procedure) gives specific instructions to PMUs and implementing agencies regarding the proper maintenance of the following books and registers for the advance account:

- (i) cashbook;
- (ii) departmental appropriation (votes) ledger;
- (iii) journal;
- (iv) withdrawal application register;
- (v) advance fund register for first-generation imprest accounts (FGIAs), second-generation imprest accounts (SGIAs), and third-generation imprest accounts (TGIAs);
- (vi) advance fund reconciliation register;
- (vii) general ledger account for FGIAs and SGIAs;
- (viii) register of advance funds released to TGIAs; and
- (ix) advance fund register at implementing agencies, units, and TGIAs.

This list of books and registers is from a circular issued in 2002, when the terminology mentioned was still in use. However, the terms "FGIA," "SGIA," and "TGIA" are now defunct. FGIAs are now referred to as "Advance Account" and TGIAs, as advance sub-accounts. ADB has stopped using the term "TGIA" in its loan documents.

Further, the advance accounts maintained at different levels should be reconciled with one another on a monthly basis, and an advance account reconciliation statement for the whole year must be prepared and attached to the final accounts.

Chart of Accounts

Under the government's Financial Regulations, project accounts must be maintained according to donor requirements. The government has issued no specific guidance regarding the chart of accounts for project executing agencies. However, the government prepares its accounts on the same chart of accounts as that used for the national budget.

Project withdrawal applications submitted by the PMUs together with a letter to the relevant executing agency include, among other details, the appropriate budget code for each withdrawal. This code, along with the PMUs' monthly expenditure summary, facilitates accounting in the executing agency system based on the government chart of accounts.

Accounting Method

Under Financial Regulation 626, projects should maintain separate accounting records in accordance with accepted accounting principles, which require the adoption of accrual accounting procedures. Projects must maintain books and records using double-entry accounting. All project transactions are periodically summarized and reported to the government and ADB according to government regulations (Financial Regulation 625 and relevant circulars including DSA Circular No. 30/94 on foreign aid accounting) and donor requirements.

Computerized Accounting System and Level of Automation

The Computerized Integrated Government Accounting System (CIGAS) has been widely used in government since its introduction in 1995. It is now used by all Treasury departments and by the various ministries, departments, and agencies as well as the provincial councils, but without the benefit of real-time connectivity. The system automates the critical accounting processes of government accounting units and transmits the accounts from grassroots level to the Treasury at the top level. These accounts are consolidated at the DSA through the AS/400 Treasury Accounting System. Although the CIGAS chart of accounts could go down to the service delivery level, the system is not being fully implemented at present. The CIGAS has been further improved to enable the recording of asset data in financial statements starting in 2015. A major new system, the Integrated Treasury Management Information System (ITMIS), is being developed to replace the CIGAS.²² The implementation of the ITMIS will bring public finance management online, while also incorporating commitment accounting, contract management, and asset management. These elements will facilitate the migration to accrual-based accounting.

As for the PMUs, they can have their own computerized accounting systems. The PMUs are free to adopt their own systems and mainly use project-specific financial information systems that integrate project, procurement, and financial management systems for accounting and financial reporting. Unlike CIGAS, these systems may also assist in contract monitoring.

The Financial Regulations have not been updated for computerization and do not include requirements that normally apply to computer systems such as access controls. However, DSA Circular No. 236/2014 gives guidance regarding system control aspects for new CIGAS users.

²² The ITMIS is supported by ADB under its Fiscal Management Efficiency Project, which is aimed at creating more fiscal space by improving tax administration and compliance through the Revenue Administration and Management Information System, and to increase the efficiency of public financial management by improving information and management systems.

E. Responsible Units

Accounting Units

According to Financial Regulation 124, it is the duty of the minister of finance and planning to account for all receipts and payments to Parliament. The minister therefore assigns the secretary of each ministry as chief accounting officer (CAO), to supervise departmental financial transactions and ensure the adequacy of financial administration at the ministry, including all departments coming within the purview of that ministry. For departments not supervised by the secretary of the ministry, the officer in charge is the department's CAO.

At the department level, Financial Regulation 125 requires the head of each department to serve as the accounting officer for all financial transactions of the department. The accounting officers are responsible to the CAO for the financial administration of the departments and the management of the relevant expenditure heads.

For projects, the size of the accounting unit is determined by the size of the project. PMUs generally have an accounting unit, while subproject coordinating units (SPCUs) may have an accounting unit or an accountant, depending on the size of the SPCU.

Accounting Staff

Public sector accountants belong to the Sri Lanka Accountants Service. Enrollment in the service is based on an open competitive examination consisting of six 3-hour papers on financial management, and requires a university degree in accounting or equivalent to qualify for entry.

In the public finance system, the CAO of a ministry is the secretary of the ministry, who is generally from the SLAS and does not need to have accounting qualifications.

The position of project accountant can generally be considered a managerial position. Management Services Circular No. 33 of 5 April 2007 requires manager-level project staff to have chartered or corporate membership in a recognized institution, or postgraduate qualifications in the relevant field with minimum experience of 5–10 years, depending on the value of the project. Class I officers of the government's All Island Service or of similar status in the relevant field, with 3–8 years' experience at the class I level, depending on the value of the project, also qualify at this level.

Decentralized Financial Management Model

For projects decentralized to the provincial level, there are SPCUs with separate accounting units. The SPCUs prepare annual financial plans and financial statements, and submit these to the PMU. The PMU accounting unit is responsible for consolidating the financial plans and reports of the PMU and all SPCUs. It also has a key role in donor coordination and fund disbursement.

F. Fiscal Year

According to Financial Regulation 1, the financial year of the government starts on 1 January of each year and ends on 31 December of the same year. SLPSAS-1 (Presentation of Financial Statements) requires reporting at least once every year. If an entity's reporting date changes and the period is longer or shorter than 1 year, the entity must disclose, in addition to the period covered by the statement, the reason for the change and the fact that certain figures may not be entirely comparable. The financial year for ADB-funded projects is generally in line with the government's fiscal year.

G. Project Financial Statements

Preparation of Financial Statements

Project executing agencies are required to submit financial statements to ADB and the relevant government agencies. Financial Regulation 150 requires government accounting officers to prepare appropriation accounts as soon as possible after the end of the year.

Government reporting formats do not necessarily facilitate the presentation of all the information required by donors. For this reason, Financial Regulation No. 626 provides for annual accounts of projects to be based on separate accounting records in accordance with accepted accounting principles. Project financial statements are prepared yearly. These statements are prepared by the project accountant and must be approved by the secretary of the line ministry or the chairman of the implementing agency, the project director, and the chief financial officer.

Format of Financial Statements to Be Submitted to Government Agencies

Recurrent and capital expenditure for foreign-funded projects is recorded in Treasury books with the appropriate object code and financing details. The government's Financial Regulations and relevant circulars²³ require accounting officers to report foreign aid project expenditure to the Treasury, through the monthly summary of accounts or transfer orders, under the relevant head-program-project-object code and financing code. Executing agencies include these details in the cover letter accompanying withdrawal applications sent to the central bank through the TOD.

DSA Circular No. 30/94 (Foreign Aid Accounting) gives guidelines and formats to ministries and departments for reporting of foreign aid to the relevant government departments, which includes departments of external resources, Treasury, and state accounts. Reports contain guidelines and recommended formats for the reporting of foreign aid by the various ministries and departments, including the ERD, the Treasury, and the DSA. Reports are submitted monthly, quarterly, or yearly.

²³ Financial Regulation 625 and DSA Circular No. 30/94 (Foreign Aid Accounting).

Provincial councils report monthly to the MLGPC the expenditures incurred on grants received from the central government. They also submit their accounts yearly to the DSA in the same format used by the ministries for their annual appropriation accounts. However, provincial council reports are not consolidated into the central government's financial reports.

Submission of Financial Statements

Financial Regulation 626 requires the submission of annual financial statements for projects to the project donor as provided in the loan agreement. Audited project financial statements are sent by the auditor general to the secretary of the relevant ministry, who forwards these to ADB.

Deadline for Submission of Financial Statements

Under the SLPSAS, an entity must issue its audited financial statements within 6 months of the reporting date. The complexity of an entity's operations is specifically noted as being an insufficient reason for failing to report on time.

The deadline for the submission of audited financial statements to ADB is mentioned in the loan agreement. It is generally 6 months from the end of the financial period for most projects, and 9 months in the case of large, decentralized projects. The PMU is expected to submit its statement to the Auditor General's Department within 3 months from the end of the financial year.

VIII. Auditing Arrangements

Article 154 of the Constitution mandates the auditor general to audit public sector institutions, including all departments; offices of the President, the Prime Minister, and the Cabinet of Ministers; commissions; local authorities; public corporations; businesses or other undertakings vested in the government under written law; and companies registered under the Companies Act in which the government or a public corporation or local authority holds 50% or more of the shares.²⁴ The audit of over 1,500 financial statements and accounts of government institutions, including foreign-funded projects, is vested in the auditor general. Annual audit plans are prepared by the superintendents of audit and approved by the auditor general by around June or July.

The auditor general has discretion to decide the scope of the audit, and is guided in this regard by the Sri Lanka Accounting and Auditing Standards Act No. 15 of 1995 and by the International Standards of Supreme Audit Institutions issued by the International Organization of Supreme Audit Institutions. As regards public corporations, Finance Act No. 38 of 1971 requires the auditor general to examine the following:

- (i) whether the organization's systems, procedures, books, records, and other documents have been properly and adequately designed from the point of view of the presentation of information and enable a continuous evaluation of the activities of the corporation, and whether such systems, procedures, books, records, and other documents are in effect;
- (ii) whether the conduct of the corporation has been in accordance with the laws, rules, and regulations relevant to the corporation, and whether the corporation has been administered fairly;
- (iii) whether there has been economy and efficiency in the commitment of funds and the use of such funds;
- (iv) whether fund and property management systems are satisfactory;
- (v) whether the accounts audited have been so designed as to present a true and fair view of the affairs of the corporation for the period under consideration, given the principles of accountancy, financing, and valuation; and
- (vi) all other matters deemed necessary by the auditor general.

The audit methodology practiced by the AGD complies with the SLAS and the auditing standards of the International Organization of Supreme Audit Institutions. The auditor general's office conducts both financial and performance audits. In 2011, risk-based

²⁴ Companies registered or deemed to be registered under the Companies Act in which government has a major shareholding came within the purview of the AGDSL with the 19th Amendment, tabled in Parliament on 28 April 2015.

financial statement audit procedures using modern electronic audit technology were introduced on a pilot basis. The reporting pattern for public corporations, ministries, and departments was revised.

The auditor general reports to the legislature and presents reports to Parliament based on detailed audit reports submitted to the management of the relevant public institution within the purview of the auditor general's audit. These reports must be presented to Parliament by 31 October. Two legislative committees, namely, the Committee on Public Accounts (COPA) and the Committee on Public Enterprises (COPE), are tasked with scrutinizing the implementation of the national budget by examining these external audit reports and asking responsible parties about the findings. Audit reports for foreign-funded projects are also audited by the auditor general and subject to review by the legislative committees.

A. Auditing Requirements

Financial Regulation 626 and DSA Circular No. 30/94 (Foreign Aid Accounting) require the submission of annual accounts for each project, duly audited by the auditor general, to the donor, as stipulated in the loan or credit agreement. A project that does not have a special provision requiring the preparation of separate financial statement or audit reports is deemed to be covered by the audit of the ministry or department under which the project is being implemented. The AGD carries out an external audit of a selected number of such projects during the audit of the ministries, departments, and agencies concerned. The findings for these projects are highlighted in the audit report for the relevant ministries, departments, and agencies. Of the 400 or so projects being implemented, around a third require a separate external audit. ADB agreements compel the borrower to appoint an independent auditor acceptable to ADB for the audit of project financial statements. The local practice calls for the AGD to audit ADB project, with no subcontracting to private firms or individuals.

The Office of the Auditor General, under internal circular AG/SEC/2015/13 of 22 June 2015, gives guidance to all divisional heads, superintendents of audit, and group officers in the audit of foreign-funded projects. The circular provides direction regarding the areas to be covered in the management report and the audit report (including specimen reports), the format of the main audit file, and the timing of report submission, and is applicable to the preparation of audit reports for foreign-funded projects from the end of 2014. The circular also indicates that an audit manual related to audit of financial statements of foreign-funded projects will be issued in due course.

Audit reports for foreign-funded projects consist of the statutory audit report and the letter of management or management report. The statutory audit report is a legal obligation; the management letter, on the other hand, points out weaknesses in fund management and financial reporting with the aim of improving efficiency.

The auditor is expected to review key areas during the audit (Box 8).²⁵

²⁵ Auditors' responsibility per specimen for financial report, and scope of audit per specimen for Management Report in AGD Circular AG/SEC/2015/13 of 22 June.

Box 8: Key Areas Covered by the Audit

Whether the internal control systems provide adequate control over project management

Whether the presentation of expenditure in the financial statements for the project satisfactorily comply with the requirements for improved financial and progress reporting

Whether adequate accounting records are continuously maintained to show project expenditure from the funds of the government and the lending or donor agency, the financial and physical progress of the project, the assets and liabilities arising from project operations, the purchases made under the loan or grant, etc.

Whether withdrawals under the loan or grant conform to the specifications in the loan or grant agreement

Whether the funds, materials, and equipment supplied under the loan or grant are being used for the project

Whether expenditure has been correctly identified according to the classification adopted for the project

Whether the financial statements are based on the Sri Lanka Accounting Standards, Generally Accepted Accounting Principles, or Sri Lanka Public Sector Accounting Standards

Whether the initial deposit or opening and closing balances, or withdrawals from and replenishments to the special (dollar) account or advance fund, have been truly and fairly disclosed in the books and records maintained for the project; and the balance as of 31 December has been satisfactorily reconciled with the accounting records of the Central Bank of Sri Lanka as of that date

Whether satisfactory measures have been taken by the management to rectify the issues highlighted in the previous year's audit report

Whether the financial covenants laid down in the loan or grant agreement have been complied with

Source: Internal circular AG/SEC/2015/13 of the Auditor General.

Guidelines with regard to audit files related to donor-funded projects must include all necessary information such as a copy of the financial statements for the year under review signed by authorized officials; a management assertion letter, which is a statement of management responsibility for the preparation of the financial statements and the provision of the necessary information to the auditor; a project profile statement prepared by the superintendent of audit; and a minimum audit program and a completed checklist attesting to the comprehensiveness of the audit work done and to its compliance with quality standards.

The timeline for the submission of audit reports varies between donors. AGD internal circular AG/SEC/2015/13 sets the following timelines for the issuance of ADB project audit

reports: the management report by 31 May, the draft audit report by 10 June, and the final audit report by 30 June. Although the period for audit by AGD is generally 3 months, for more complex projects, a period of 6 months is allowed. However, in practice, it appears that these deadlines are not always met because of resource limitations. After the audit, the AGD issues the report to the secretary of the line ministry or the chairman of the implementing agency, who forwards it to ADB.

The minister of finance has the overall responsibility for supervising public finance administration in the country. Audit duties are therefore not the exclusive responsibility of the auditor general. The minister of finance (under Financial Regulation 155) may authorize an additional audit by any other person or organization of the minister's choice. Given the common delays in audits, ADB could consider encouraging the AGD to outsource the external audit to independent auditors. In the case of public enterprises, such additional audits are subject to the articles of incorporation of the public enterprise.

The statutory audit report and the management letter are among the key reports considered by ADB in its further discussions with the responsible government agency on project financial management issues.

B. Resolution of Problems Raised in External Audit Reports

Resolution by ADB

The auditor general's management report includes recommendations for improving project accounting and other policies, which the donor should follow up with the executing agency. Under Financial Regulation 155, chief accounting officers and accounting officers must respond promptly and accurately to queries from the AGD. Some donors—such as the United Nations Development Programme; the Global Fund to Fight AIDS, Tuberculosis and Malaria; and the Japan International Cooperation Agency—have been very proactive in following up on the observations made in the management report. At the donor's request, the AGD conducts a review and issues a settlement certificate to indicate that the matter raised has been addressed by the executing agency. ADB could consider this practice of issuing settlement certificates a useful tool for better financial management.

Resolution by Government

Any significant project findings are included in the reports of the relevant ministry or corporation, and presented to Parliament for COPE and COPA review. However, the institution is first given an opportunity to submit its observations on the draft audit reports before they are tabled in Parliament. COPE and COPA may then direct questions to representatives of the relevant institution. Government agencies may review audit reports of projects to understand how best to implement recommendations to improve the financial and management efficiency of the project.

IX. Summary of Risks and Issues, and Proposed Mitigating Actions and Improvements

The table below summarizes the risks and issues in the country financial management systems that may affect project implementation. These risks and issues should be considered by project officers and mission leaders when designing financial management arrangements and when conducting financial management and risk assessments.

Some useful references and suggested readings are provided in the Appendix.

Common Issues, Problems, and Suggestions for Mitigating or Avoiding Risks

Observation	Recommendation
Provincial Local Budget Actual transfers made to provincial councils by the central government for capital expenditure (criteria-based grants and province-specific development grants) are less than the amount allocated in the central budget.	This could affect the implementation of donor-funded projects where the provincial council is significantly dependent on budgetary allocations for counterpart funds. ADB should consider this aspect when appraising provincial-level projects.
Segregation of Duties Financial regulations authorize an accounting officer to delegate functions so as to ensure adequate segregation of duties for a sound internal control system. However, the regulations also allow an accounting officer to be involved in more than one function in particular circumstances.	In practice, in particular circumstances, such as where resource limitations exist, an officer may be involved in more than one of the above functions, thus increasing the risk associated with malpractice and fraudulent activity. This possibility should be considered during project appraisal.
Audit Arrangements ADB loan agreements state a deadline for the submission of audited project financial statements to the donor. To meet these deadlines, the AGD sets timelines for the issuance of audit and management reports, draft audit reports, and final audit reports by AGD staff. However, in practice, there are delays in meeting these deadlines because of resource constraints. The AGD does not subcontract project audits to private firms or individuals.	ADB should hold discussions with the borrower and the executing agency to ensure that the AGD has enough resources to audit the project. If resource capacity is limited, ADB may discuss with these entities the possibility of hiring an independent external auditor in accordance with ADB's financial management guidelines, at the same time that improvements are made in audit staff capacity with financial assistance from other development partners.

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Table continued

Observation	Recommendation
Follow Up on Audit Observations Some donors are very proactive in following up on the observations made in the auditor general's management report. To ensure that issues raised are resolved, these donors request the AGD to conduct a review and issue a settlement certificate to indicate that the matter raised has been addressed by the executing agency.	The practice of having settlement certificates for key issues raised could be a useful tool for better financial management.
Accounting Standards and Regulations Public corporations, such as Ceylon Electricity Board and National Water Supply and Drainage Board, that receive ADB funding adopt their own financial rules and procedures, and may be exempted, in whole or in part, from the Financial Regulations, which are generally applicable to all government institutions.	Dealing with different corporations may subject ADB projects to varying financial procedures, which could complicate disbursement verification and project monitoring. This possibility should be considered during project appraisal.
Results-Based Lending Projects Results-based lending (RBL) projects are implemented as part of ADB's government sector strategy through national budget. For results-based lending projects, ADB has a built-in monitoring system for the components it funds. However, there may not be an overarching monitoring system for the entire program. As a result, while ADB may achieve the desired results from the components it finances, the overall government program may not achieve the desired results.	ADB should consider discussing with the government mechanisms for strengthening the government's monitoring system for the program as a whole.
Availability of Project Funds The government's fiscal reform agenda may include improving the level of external borrowing. The increase could lead to insufficiency of budget allocations for project expenditure, affecting the disbursement ratio and delaying project implementation.	Project teams should discuss with government a more efficient way of allocating and disbursing funds. This should be considered in the budget process and in the design of funds flow arrangements to ensure that funds will be available during project implementation. Project teams should ensure that the annual budget allocation, including any supplementary budget allocation, fully incorporates the anticipated expenditure from all sources (including ADB, any cofinancing, and government counterpart funds). As necessary, the project administration manual may include requiring the preparation and submission of annual budget allocation requirements for the project to the government in accordance with the country's budget preparation calendar. Budget planning and disbursement projections should be agreed on with the government and the executing agencies.

ADB = Asian Development Bank, AGD = Auditor General's Department.

Source: Author.

Appendix: Useful References and Suggested Readings

Official Government Websites

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Public Financial Management Systems—Sri Lanka

Key Elements from a Financial Management Perspective

This report documents Sri Lanka's financial management systems covering budgeting, funds flow, accounting and reporting, and auditing systems. It provides insights into Sri Lanka's internal control systems, staffing resource capacity, and information technology structure. The intent is to give project teams and consultants a better understanding of the country's financial management systems in order to improve project preparation. Find out how high-quality financial management assessments support projects by identifying key risks and enabling the implementation of appropriate actions and reforms to mitigate those risks.

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