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INTRODUCTION

1. The basic purport of this assessment of public sector accounting and auditing is to facilitate more efficient Public Financial Management (PFM) through better quality accounting and public audit processes in Sri Lanka. Moreover, a greater stimulus is expected to be created for more cost-effective outcomes of government spending. The main objectives of this effort are to: (a) provide Sri Lanka's accounting and audit authorities and other interested stakeholders, with a common strongly founded knowledge regarding the status of local practices in accordance with the internationally developed standards of financial reporting and audit; (b) assess the prevailing variances; (c) chart paths to reduce the variances; and (d) provide an ongoing basis for measuring improvements.

2. Information on national standards and practices for accounting, financial reporting, and auditing in the government budget sector and in the state-owned enterprise sector were collected from diagnostic questionnaires that were completed in conjunction with country authorities. The diagnostic questionnaires incorporated the principles contained in the public sector accounting and auditing standards promulgated by International Organization of Supreme Audit Institutions (INTOSAI) and International Federation of Accountants (IFAC). The responses to these questionnaires have been further explored through discussions conducted by a World Bank team with the country authorities. These discussions included examination of accounts and audit reports and working papers to explore the quality of the processes and the products. Annex A further explains the methodology used for the study.

3. The analysis in this report has been conducted in the light of a concurrent public sector fiscal reform program supported by the Asian Development Bank (ADB) and the World Bank. Detailed studies of accounting and auditing have been conducted by ADB (Diagnostic Study of Accounting and Auditing Practices in Sri Lanka, 2002) and the World Bank (Country Financial Accountability Assessment, 2004). In addition, the United Kingdom and The Netherlands Audit Offices collaborated in producing the 2003 Institutional Development Plan for the Auditor General's Department.

4. These studies have examined the system of maintenance of public accounts in Sri Lanka in great detail. They show that the Financial Regulations (1992), which are the main authority for public financial management in the general government sector, focus only on the input aspect of expenditure control. They are issued by the executive branch (not by the legislature) and do not have the force of law. The studies found that there is a significant and long-standing practice of non-compliance with the Financial Regulations, in form and in spirit. The result is that government financial statements presenting the



financial condition of the State (the State Accounts) have not been available on a timely basis and are not comprehensive. In addition, the numbers are not completely reliable because of reconciliation and other problems. Reliability of financial data and timeliness of financial reporting have improved considerably in the presentation of financial statements for 2005. More needs to be done to develop performance budgets.

5. The Government of Sri Lanka has been making progress in improving the current state of affairs. The Financial Regulations are being transformed into a set of nine guidelines (on planning, budgeting, foreign aid, revenue management, government accounting, procurement, fixed asset management, stores management and internal auditing) as part of simplifying the procedures and systems shifting focus more on outputs. This study found that so far, only one guideline had been implemented. The State Accounts have been produced in accordance with the Cash Basis International Public Sector Accounting Standards (IPSAS) and are intended to make the transition to the accrual basis or reporting in accordance with IPSAS. A significant gap in the public financial accountability framework has been the lack of a mechanism for monitoring and reviewing outputs and outcomes of government expenditure. This requirement will become more stringent with accruals, and the process must be tightened. A proposed Public Finance Bill (incorporating references to the financial guidelines), which has been drafted, lays a firmer legal basis for improving performance and financial accountability. But, action on the same has been deferred. Public sector auditing has been improving with wider coverage of public sector bodies and reporting that is more focused on material issues and general areas of control that need improving. What does not appear to have been improving has been the response to these identified deficiencies.

6. Annex B provides a summary of accounting and auditing standards referred to in this study. Annex C and D provide accounting and auditing legislation, respectively. And Annex E includes a description of the benefits of accrual accounting. The Table of Standards and Gaps at the end of the report summarizes each component of the current accounting and auditing standards, the present position, and the options for improvements that would bring Sri Lanka into closer conformance with international standards.