



EXECUTIVE SUMMARY

1. This assessment of public sector accounting and auditing is generally meant to assist with the implementation of more effective Public Financial Management (PFM) through better quality accounting and public audit processes in Sri Lanka. It is intended to provide greater stimulus for more cost-effective outcomes of government spending. The specific objectives are (a) to provide the country's accounting and audit authorities and other interested stakeholders with a common strongly founded knowledge as to where local practices stand in accordance with the internationally developed standards of financial reporting and audit; (b) to assess the prevailing variances; (c) to chart paths to reduce those variances; and (d) to provide a continuing basis for measuring improvements

2. Adoption of international standards for accounting and auditing provides the basis for competent financial reporting and transparency. The International Public Sector Accounting Standards Board (IPSASB) of the International Federation of Accountants (IFAC) has developed a core set of accrual-based International Public Sector Accounting Standards (IPSAS) besides a comprehensive IPSAS on the cash basis of accounting. IPSAS establish an authoritative set of independent international financial reporting standards for governments and others in public sector organizations. The study has taken the international standards as axiomatic with any acceptable options incorporated in the standards. The study has not assessed whether or not the country should adopt a limited version of the standards, as the processes of developing the standards have already considered any acceptable options in their text, but they do not override authoritative national standards issued by governments, regulatory or professional accounting bodies. Application of IPSAS by national authorities will support developments in public sector financial reporting directed at improving decision making, financial management, and accountability, and it will be an integral element of reforms directed at promoting social and economic development. The IPSASB has also developed guidelines on the transition from cash- to accrual-based reporting.¹ The traditional emphasis on cash accounting has been found inadequate through failure to recognize true costs, and all assets, and liabilities. Cash accounting can too easily neglect asset management, accumulating arrears, future liabilities (e.g., pensions), and contingent liabilities (e.g., guarantees).

3. Annex A explains the methodology used for the study. Annex B provides a summary of accounting and auditing standards referred to in this study. Annex C and D provide Sri Lanka accounting and auditing legislation, respectively. Lastly, Annex E includes a description of the benefits of accrual accounting. The desired lines of action to be taken as indicated by this assessment are summarized below.

¹ *Transition to the Accrual Basis of Accounting: Guidance for Governments and Government Entities, IFAC Public Sector Committee, December 2003.*



4. The plans to build on the current reporting under IPSAS through a path to implementation of the accrual IPSAS should be supported.

An implementation program for progressive adoption of accrual reporting is underway. The IPSASB encourages governments to progress to the accrual basis of accounting and to harmonize national requirements with the IPSAS and Sri Lanka is progressing very well on this path.

5. The Table of Standards and Gaps appended at the end of this report provides a matrix detailing the current standards, the present position, and options for improvements. A summary of these accounting issues is shown in Table ES1.

TABLE ES1. SUMMARY OF ACCOUNTING STANDARDS ISSUES IN SRI LANKA

<i>Standard</i>	<i>Current status</i>	<i>Action to move towards the international standard</i>
1. Has the Public Sector Accounting Law adopted IPSAS?	Not formally. Since 2002, the Finance Department has been preparing annual accounts increasingly in accordance with the Cash Basis IPSAS. In 2005, additional disclosures were made as a first step towards presenting the account on an accrual basis. However there is no current prescription by law for the adoption of IPSAS.	A new law is not required at this time. Financial Regulations will be appropriately amended to adopt IPSAS. The Department of Public Finance of the Ministry of Finance & Planning (MOF&P) is to take the initiative by early 2007 in consultation with all stakeholders.
2. Does education and training of accountants accord with IES?	Substantially, but not formally. Government accountants are required to hold a university degree in accounting or equivalent. Further training is also provided but not in strict accordance with the IES.	A proposal for WB funding for collaboration with CIPFA is in progress and is currently under consideration by the Ministry of Finance (MOF). Implementation is likely during 2007. Director General (DG) State Accounts is to arrange to prepare a proposal to explore changes to the efficiency bar examinations in service progression with a view to including knowledge of IPSAS. DG State Accounts will also consider actions for the inclusion of IPSAS in the curriculum of universities and INGAF/SLIDA to meet IES. Progress is expected during 2007.
3. Does the Code of Ethics match international standards?	No. There is a Civil Service Code but this is not specific to accounting.	A specific code based on IFAC or the ICASL for use by public sector accountants. A Public Sector Committee (PSC) could explore the possibilities during early 2007.
4. Is there a body to prescribe public sector accounting standards?	No. ICASL provides standards for commercial accounting.	By mid 2007, DG State A/Cs to initiate a proposal for setting up a Public Sector Committee to establish standards for the government sector.

Standard	Current status	Action to move towards the international standard
5. Are the financial statements in accord with international standards?	Government accounts are substantially in accord with Cash Basis IPSAS. State-Owned Enterprise (SOE) accounts follow IFRS but the accounts are usually qualified by the auditors on serious grounds.	DG State A/Cs is to take steps to arrange compliance with IPSAS for the core Government and non-commercial SOEs during 2007. World Bank (WB) is to discuss the support required with DG State A/Cs by mid 2007.
6. Is the statement of Cash Receipts and Payments in IPSAS form?	Yes, except that third party payments are not shown separately	The 2005 accounts showed statements of financial performance, cash flows, financial position, contingent liabilities, accounting policies and notes to the accounts. The transition path now underway will make the improvements that are needed. The World Bank arranged a workshop on IPSAS on October 27, 2006.
7. Are accounting policies and explanatory notes required?	Yes.	
8. Are other disclosures in accord with IPSAS?	Yes.	
9. Does the government issue a consolidated financial statement which consolidates all controlled entities?	No. Only the Central Government Sector is covered. Public enterprises, SOE and statutory boards are not included in the accounts.	Further steps will be needed to include controlled entities and WB is to discuss the support required with DG State A/Cs by mid 2007.

6. There is a need to adopt the IFAC-issued International Standards on Auditing (ISA) in addition to the INTOSAI Auditing Standards already adopted, and auditing manuals and procedures should meet these standards. Currently the INTOSAI Auditing Standards have not formally been adopted although there is a willingness to follow their prescriptions. New and amended laws should mandate the adoption of international standards. Audit recommendations and observations go unheeded in far too many instances. The implementation of the Cabinet Decisions on a National Audit Act and the implementation of the Institutional Development Plan for the Auditor General's Department should introduce modern audit methodologies and a modern audit organization.

7. The Table of Standards and Gaps at the end of this report shows each component of the standards, the present position, and the options for improvements that would bring Sri Lanka into closer conformance with international standards. A summary of these auditing issues is shown in Table ES2.

TABLE ES2. SUMMARY OF ACCOUNTING STANDARDS ISSUES IN SRI LANKA

Standard	Current status	Action to move towards international standards
1. Is the SAI statutory framework in accord with the needs of the INTOSAI Auditing Standards?	Partly. There is constitutional support, but there is no Audit Act that deals specifically with the Auditor General's duties and functions, and provides adequate administrative and financial arrangements to ensure proper support for PFM	A draft audit act has been prepared and is awaiting approval. A decision is in prospect before the end of 2007.

Standard	Current status	Action to move towards international standards
2. Is there a body to prescribe public sector auditing standards?	No	The AG and the DG State A/Cs will coordinate the proposal for setting up of a PSC with the ICASL to establish standards for the government sector by mid 2007.
3. Have INTOSAI and IFAC audit standards been adopted?	Yes, but there is no document that lists out the public sector audit standards.	No action required until the Audit Act is passed.
4. Has a code of ethics equivalent to the INTOSAI standards been adopted?	No. The Code of Conduct for Public Sector Accountants is mainly based on the Establishment Code for Public Servants.	The proposed IDP likely to be implemented during 2007 will adopt a code of ethics equivalent to the INTOSAI Code.
5. Is the accountability process in the SAI in accord with INTOSAI Auditing Standards?	Yes.	
6. Does the SAI legal framework meet the INTOSAI standards for independence and powers?	No. For example, greater independence is needed in the areas of administration and resources.	The draft act addresses most of the eight core INTOSAI principles of independence.
7. Does education and training of auditors accord with INTOSAI and IES standards?	Not sufficiently. Peer reviews of the AG Department have shown several inadequacies.	A proposal for funding CIPFA collaboration is under discussion between MOF and the WB. The Institutional Development Plan (IDP) implementation will address skills analysis during 2007 and 2008.
8. Is the SAI equipped with the audit methods and technologies to meet the INTOSAI Auditing Standards?	No. The current audit methods are attuned to budget compliance checking. Major changes to audit methods are needed to support certification audit. Greater technology is needed.	The Institutional Development Plan prepared by the UK and The Netherlands SAIs will correct these deficiencies and implementation of the IDP is under discussion with the WB. Action is likely during 2007.
9. Does the SAI have the quality assurance programs to meet the international standards?	No.	
10. Does the process to plan the audits meet international standards?	Partly. Audit planning is not sufficiently tailored to the audit client.	

Standard	Current status	Action to move towards international standards
11. Does the process to supervise the audits meet international standards?	No. Working paper systems are insufficient to support proper supervision.	
12. Does the process to evaluate the reliability of internal control meet international standards?	No. The orientation is to identify deficient transactions rather than verify the systems of control.	
13. Does the process used in audits to assess compliance with laws meet international standards?	Yes.	
14. Does the audit process used to obtain evidence to support conclusions meet the international standards?	No. Working paper systems are insufficient.	
15. Does the audit analyze the financial statements to establish whether acceptable accounting standards for financial reporting and disclosure are complied with?	Yes.	
16. Does the auditor prepare an audit opinion on the financial statements in a form that conforms to international standards?	Yes.	
17. Does the consideration of fraud and error in an audit of financial statements conform to international standards?	Yes.	
18. Is the process for taking action on audit recommendations sufficiently effective to meet international standards?	No. There is an inadequate system for response.	An appropriate system needs to be set up.

8. Public Financial Management (PFM) should be improved through a more ambitious and comprehensive reform program. Rapid progress is being made toward adoption of accrual reporting along IPSAS lines. Public financial management relies on a comprehensive and timely accounting and financial reporting system that is supported by competent assurance from a professional audit function, stating that the system is working properly and that the information is reliable. Current enforcement of adequate compliance with Financial Regulations in the general budget sector and corporate governance in the public enterprise sector falls short of satisfactory standards. Use of the PFM performance measurement framework developed by the Public Expenditure and Financial Accountability (PEFA)² program will be a good basis to develop and measure progress in the full cycle of PFM reform from budget formulation to legislative scrutiny and remedial action.

9. Improvement of accounting and auditing skills. Improved compliance with international standards requires properly trained staff. Basic accounting and auditing skills are good but post graduate skills are required that suit Sri Lankan conditions. The proposed improvement of accountancy training institutions through the adoption of the Diplomas and Certificates issued by the Chartered Institute of Public Finance and Accountancy in the United Kingdom should be used to strengthen public sector accounting and auditing skills.

10. The preparation of a PFM indicators survey that provides the basis for monitoring progress in adopting and applying international standards. Improvement of audit impact should be monitored through the progress of the institutional strengthening proposed for the Office of the Auditor General over the next few years.

² The PEFA Program is a partnership among the European Commission, the UK Department for International Development, the Swiss State Secretariat for Economic Affairs, the French Ministry of Foreign Affairs, the Royal Norwegian Ministry of Foreign Affairs, the Strategic Partnership with Africa, IMF, and the World Bank. A Steering Committee, comprising members of these agencies, manages the Program. A Secretariat is located in the World Bank in Washington, DC.