

# REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC) Sri Lanka

## ACCOUNTING AND AUDITING

May 21, 2004

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### EXECUTIVE SUMMARY

Sri Lanka has made considerable efforts in aligning its accounting and auditing practices with international standards to establish a high-quality corporate financial reporting system. Corporate accounting and disclosure practices, particularly for publicly traded companies, have improved over the past decade. Among forward-looking actions has been the enactment of the Sri Lanka Accounting and Auditing Standards Act and establishment of the Sri Lanka Accounting and Auditing Standards Monitoring Board.

However, there appears to be a certain degree of noncompliance in both accounting and auditing practices, resulting mainly from weak enforcement. The weakness is primarily attributed to inadequate regulatory capacity. Despite Sri Lanka's retinue of highly skilled, qualified accountants who are capable of providing world-class services, the country's regulatory regime is still constrained by lack of technically qualified human resources. Moreover, an absence of implementation guidance, coupled with knowledge gaps in many cases, hinders the uniform application of accounting and auditing standards.

This report provides an appraisal of the accounting and auditing practices within a broader context of the Sri Lanka institutional framework and the capacity needed to ensure high-quality corporate financial reporting. Building on past achievements, comprehensive efforts are necessary for strengthening the capacity of regulators and ensuring effective coordination among them. Also, there is an urgent need for a system of independent oversight of the audit profession that will protect public interest.

This report provides a wide range of policy recommendations focusing on building regulatory capacity, strengthening enforcement mechanisms, initiating legal reforms, undertaking awareness programs for shareholders and top management, urging compliance with guidelines of the International Federation of Accountant, improving education and training, introducing independent oversight of the audit profession, strengthening the professional association, publicizing more widely the enforcement actions against noncompliances, upgrading the licensing procedures for accountants and practicing auditors, and disclosing audit and nonaudit fees separately. These recommendations are expected to provide inputs for designing a country action plan that will further improve the accounting and auditing regime of Sri Lanka.

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This report, prepared by a team from the World Bank, is based on findings from a diagnostic review carried out in Sri Lanka in November–December 2003. The review was conducted through a participatory process involving various stakeholders and led by the country authorities. The World Bank ROSC team was led by M. Zubaidur Rahman (OPCFM).

## I. INTRODUCTION

1. This report is based on a review of strengths and weaknesses of corporate accounting and auditing practices in Sri Lanka. It forms a part of the World Bank and the International Monetary Fund (IMF) joint initiative on Reports on the Observance of Standards and Codes (ROSC). The review involved assessment of actual practices and analysis of effectiveness of monitoring and enforcement mechanisms. International Accounting Standards (IAS)<sup>1</sup> and International Standards on Auditing (ISA) served as benchmarks for evaluating international comparability of locally applicable accounting and auditing requirements. The review used a diagnostic template developed by the World Bank to facilitate collection of data. The data was complemented by the findings of a due diligence exercise based on a series of meetings with key stakeholders and conducted by World Bank staff. The intended audience of this report includes national and international market participants who have an interest in the corporate financial reporting regime of Sri Lanka. The policy recommendations of this report are expected to provide inputs for developing and implementing a comprehensive action plan for strengthening institutional capacity to support high-quality corporate financial reporting.

2. Sri Lanka has a population of approximately 19 million and covers a geographic area of 65,610 square kilometers. This South Asian country began to shift away from a socialist orientation in 1977 toward market-oriented policies. While the country's per capita income (US\$830) remains the second highest in the region, Sri Lanka's economic performance has not kept pace with the East Asian countries who were its peers in the 1960s. The 20-year civil conflict in Sri Lanka adversely affected its economy. Moreover, sluggish progress in key structural areas, including civil service reform; restructuring of state-owned enterprises; and financial, land and labor market reforms have largely undermined the country's growth potential. About 0.8 million Sri Lankans work abroad, sending back to the country about US\$1.1 billion a year.

3. In the recent past, there has been a significant capital market recovery. With a permanent cease-fire in effect, and the efforts to eliminate factors which inhibit the restraints on private sector activity, the foreign portfolio investors have been showing increased interest in Sri Lankan stock market. The total market capitalization on December 10, 2003, was about US\$31 billion with the foreign holding worth of US\$5 billion. A financial reporting regime, compatible with international standards and best practices, is of paramount importance for enhancing investors' confidence.

## II. INSTITUTIONAL FRAMEWORK

### A. Statutory Framework

4. **The Sri Lanka Accounting and Auditing Standards Act No. 15 (1995) introduced standard setting and monitoring arrangements for accounting and auditing of specified**

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<sup>1</sup> Within this report, IAS refers to all standards and related interpretations issued by the former International Accounting Standards Committee (IASC) and the International Financial Reporting Standards (IFRS) and related interpretations issued by IASC's successor body, The International Accounting Standards Board (IASB).

**business enterprises (SBEs).** This Act provides the framework of institutional arrangements for setting accounting and auditing standards and monitoring the implementation of those standards for the Specified Business Enterprises<sup>2</sup> operating in Sri Lanka. It has empowered the Institute of Chartered Accountants of Sri Lanka (ICASL) to issue SBE-applicable accounting and auditing standards. The Act provides for the formation and functioning of the Accounting Standards Committee<sup>3</sup> and Auditing Standards Committee<sup>4</sup> that make recommendations to the ICASL in adopting accounting and auditing standards. It has also established the Sri Lanka Accounting and Auditing Standards Monitoring Board<sup>5</sup> (hereafter referred to as “Monitoring Board”) to monitor and enforce compliance with Sri Lanka accounting and auditing standards. The Act has an indemnity provision for the Monitoring Board and its officials with regard to their action against noncompliances. Although the Act has given power to the Monitoring Board for monitoring auditors’ activities, confusion exists in the country among the auditing community with regard to its jurisdiction over monitoring the professional activities of the auditors. The Monitoring Board operates with limited resources under the purview of the Ministry of Finance.

5. **The Companies Act No. 17 (1982) provides basic requirements relating to financial reporting of all companies incorporated in Sri Lanka.** The Companies Act, among other things, provides requirements for preparation, presentation, and publication of financial statements, disclosures, and auditing for the companies incorporated under the Act. The contents and form of financial statements are prescribed in the Fifth Schedule of the Act. It is mandatory for group companies incorporated in Sri Lanka to prepare consolidated financial statements. The Act requires that the financial statements of the companies be audited annually. The Seventh Schedule of the Act outlines the specific matters to be stated in the auditor’s report. The Companies Act does not specify effective sanctions against errant preparers and auditors of financial statements.

6. **The Companies Act spells out obligations of company directors with regard to preparation of annual financial statements, but it does not include provisions on auditors’ duties and responsibilities.** Company directors are responsible for ensuring timely preparation and filing of annual financial statements with the Registrar of Companies. Directors are also

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<sup>2</sup> SBEs include all publicly traded, insurance, and finance companies; banks; stock exchanges, public corporations engaged in sale of goods and services; group companies, and other companies falling under the purview of any of the five criteria: (a) yearly turnover exceeding Rupees (LKR) 500 million, (b) shareholders equity exceeding LKR100 million, (c) gross assets exceeding LKR300 million, (d) liabilities to banks and other financial institutions exceeding LKR100 million, and (e) number of employees exceeding 1,000.

<sup>3</sup> The Accounting Standards Committee is comprised of 12 part-time members, of which 6 represent ICASL.

<sup>4</sup> The Auditing Standards Committee is comprised of 8 members, of which at least 4 must be members of the Accounting Standards Committee. The Auditing Standards Committee members are nominated by the ICASL Council.

<sup>5</sup> The Sri Lanka Accounting and Auditing Standards Monitoring Board is governed by 13 members, including 3 ex-officio members (the Registrar of Companies, the Commissioner General of Inland Revenue, and the Director General of Securities and Exchange Commission) and 10 members appointed by the Minister of Finance, including an officer nominated by the Governor of the Central Bank of Sri Lanka, 3 members from a panel nominated by the ICASL, 1 member from the Sri Lanka Division of Chartered Institute of Management Accountants (CIMA) of the United Kingdom, 1 senior lawyer nominated by the Bar Association of Sri Lanka, 2 company directors, 1 senior banker nominated by the Sri Lanka Bankers Association, and 1 senior accounting or business management academic from a panel nominated by the University Grants Commission. A perception exists that the governance of the Monitoring Board is largely influenced by practicing auditors, and this often impedes the Board in taking measures against auditors.

responsible for making these financial statements available to all shareholders at the annual general meeting. Noncompliance with legal responsibilities may lead to a director receiving a fine not exceeding 2,000 Sri Lankan Rupees (LKR) or imprisonment for a term not exceeding 6 months, or both. In reality, effective punitive action is hardly ever taken to enforce compliance with these requirements. The Act does not have any specific provisions referring to auditors' duties, obligations, and responsibilities.

7. **The Securities and Exchange Commission (SEC) of Sri Lanka considers accounting and reporting issues in regulating publicly traded companies.** Publicly traded companies<sup>6</sup> in Sri Lanka are required to comply with SEC requirements as outlined in the Securities and Exchange Commission of Sri Lanka Act No. 36 of 1987 (amended in 2003). In order to protect investor interests, the SEC issues various rules, including accounting and auditing requirements and the listing requirements that specify routine and nonroutine disclosures applicable to publicly traded companies. Through a Memorandum of Understanding with the Monitoring Board, the SEC has agreed to refer cases of noncompliance with Sri Lanka Accounting Standards to the Monitoring Board.

8. **The Banking Act No. 30 (1988, amended by Act 33 of 1995) authorizes the Central Bank of Sri Lanka to regulate financial reporting by banks.** The accounting and auditing requirements outlined in the Banking Act are in addition to the requirements set by the Companies Act. The Central Bank of Sri Lanka, empowered by the Banking Act, has prescribed formats for balance sheets and income statements, including the disclosure requirements, in line with Sri Lanka Accounting Standard (SLAS) 23 that each bank must follow. All commercial banks must publish audited financial statements within five months of the end of the financial year. Included among mandatory reporting required under the Act is provision of a monthly statement of assets, liabilities, and liquidity ratios; quarterly statements on nonperforming assets exceeding LKR500,000; risk-based capital calculations; and year-end financial statements, including detailed notes and accounting policies. The financial statements of the banks must be audited by the selected qualified auditor from the list maintained by the director of the Central Bank's Supervision Department. The list contains both large and small firms. The Central Bank has issued guidelines relating to auditor's statutory duties focusing on various issues, such as audit planning, scope of audit, evaluation of internal control, and review of financial statements. These guidelines are broadly in conformity with the ICASL pronouncements. The Central Bank has authority to enlarge the scope of audit work, requiring auditors to comply with additional requirements.

9. **The Central Bank of Sri Lanka requires publication of banks' financial statements in newspapers on a quarterly basis.** Through a circular issued in 2003, the Central Bank's Supervision Department has made it mandatory for all commercial banks and specialized banks operating in Sri Lanka to publish their quarterly unaudited financial statements within two months of the closure of each quarter. However, these financial statements, which are published in newspapers, do not have any accompanying notes or disclosure of relevant accounting policies.

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<sup>6</sup> As of December 2003, there are 244 publicly traded companies operating in Sri Lanka.

10. **The Insurance Board of Sri Lanka under the Regulation of Insurance Industry Act No. 43 (2000) regulates the financial reporting practices of insurance companies.** Insurance companies must comply with the requirements of the Insurance Board of Sri Lanka (IBSL) in preparing and presenting their financial statements. The auditors of insurance companies' financial statements must be selected from the list of IBSL-approved auditors. The Act requires that these audited financial statements be submitted to the Insurance Board of Sri Lanka; however, it does not stipulate any specific time frame for such submission. The Act requires that an actuary certify whether the reserves of the insurer are adequate to meet all liabilities.

11. **The Finance Companies Act No. 78 (1988) regulates the finance companies in Sri Lanka and sets their accounting and reporting requirements.** The Act lays down the disclosure requirements for finance companies operating in Sri Lanka. Among requirements in the Act is that companies disclose the market value of investments in their balance sheet. The audited financial statements are required to be published within six months of the financial year-end.

12. **Section 8 of the Colombo Stock Exchange Listing Rules requires presentation of interim financial statements.** As a listing requirement, the publicly traded companies are required to prepare and submit interim financial statements to the Colombo Stock Exchange.<sup>7</sup> This requirement includes two submissions: (a) quarterly financial statements by enterprises listed on the Main Board within two months of the end of the quarter and (b) half yearly financial statements by the enterprises listed on the Second Board and Debt Securities Board within two months of the end of the half year. Additionally, the listing rules require the disclosure in the financial statements of a full list of investments held by the enterprise (quoted and unquoted) held outside the group and names of the 20 largest equity holders, including the number of securities and the percentage of each of their capital holdings.

13. **The Inland Revenue Act No. 38 (2000) requires all companies to submit audited annual financial statements with their tax returns.** The Act requires the companies to submit their annual tax return to the Department of Inland Revenue in a prescribed format by November 30 of each calendar year, together with audited financial statements. The companies derive corporate income for tax purposes after adjusting relevant figures from their general-purpose financial statements, as per applicable provisions and allowances under the Inland Revenue Act.

14. **Article 154 of the Sri Lanka Constitution empowers the Auditor General to undertake audits of public corporations.** Public corporations must submit their annual financial statements for auditing to the Auditor General within four months of the completion of the corporation's financial year. Article 154 of the Sri Lanka Constitution mandates the Auditor General to conduct audit functions with respect to public corporations and report the findings to the Sri Lankan Parliament.<sup>8</sup> Thus the financial statements of the specified business enterprises, falling under the purview of public corporations, would require auditing by the Auditor General. The Auditor General would typically appoint an audit firm to carry out the audit functions for the

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<sup>7</sup> These financial statements should be prepared in conformity with SLAS 35, *Interim Financial Reporting*, and signed by one or two director(s) and the chief executive officer of the enterprise.

<sup>8</sup> These public corporations do not include the public companies registered under the Companies Act.

specified business enterprise. The Auditor General signs the completed audit report, which does not mention the name of the audit firm that actually conducted the audit.

## **B. The Profession**

15. **The Institute of Chartered Accountants of Sri Lanka regulates the accountancy profession.** Replicated on the Institute of Chartered Accountants of England and Wales, the ICASL was established in 1959 by the Institute of Chartered Accountants Act No. 23 (1959). The ICASL acts as both an examining body for certifying chartered accountant qualifications and the licensing authority for its members engaged in public auditing practice. The ICASL has 2,450 members, of which more than 500 are in public (auditing) practice in Sri Lanka.<sup>9</sup> Among other members, more than 600 are employed in foreign countries and about 1,300 work in industry and government in Sri Lanka. The ICASL Council elects a president, who is also the chief executive officer of ICASL, to a two-year term. The Council is responsible for the overall administration and management of ICASL.

16. **The four largest international accounting firm networks audit most of the publicly traded companies.** There are 412 audit firms operating in Sri Lanka, including the members of the Big-4 international accounting firm networks. The local Big-4 members audit the majority of publicly traded companies, banks, insurance, and finance companies. The Big-4 audit approximately 77 percent of the publicly traded companies,<sup>10</sup> and the medium-size local firms audit the remaining 23 percent. The smaller firms mostly concentrate on tax cases, along with performing bookkeeping services and conducting audits for small companies.

17. **Despite a few high-profile corporate failures, which have generated discussions by stakeholders with regard to the auditors' role, there have been no legal cases or other punitive sanctions against auditors.** Sri Lanka has had few high-profile corporate failures. In the wake of the collapse of several finance companies in the late 80s and early 90s, the Government of Sri Lanka established the Presidential Commission on Finance and Banking to investigate the causes of such failures and to recommend measures for strengthening the country's financial sector arrangements. The Commission stressed the need for adoption and enforcement of accounting and auditing standards for establishing a high-quality corporate financial reporting regime.<sup>11</sup> Furthermore, the Commission recommended better performance of responsibilities by auditors in preventing such failures.<sup>12</sup> Even with these measures, as recent as 2003, there was a failure of a savings and development bank in Sri Lanka. Despite such failures, there have been no legal actions or other administrative measures taken against auditors.

18. **The boards of directors of several publicly traded companies, banks, and other financial institutions include practicing auditors.** In many cases, audit firm partners sit on the boards of publicly traded companies, banks, insurance and finance companies in Sri Lanka.

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<sup>9</sup> Figures as of December 2003.

<sup>10</sup> One of the members of the largest international accounting firm networks alone audits 41 percent of the publicly traded companies in Sri Lanka.

<sup>11</sup> *Sixth Interim Report of the Presidential Commission on Finance and Banking on Finance Companies*, August 31, 1992.

<sup>12</sup> *Seventh Interim Report of the Presidential Commission on Finance and Banking on Commercial Banks and Other Deposit Taking Institutions*, November 4, 1992.

Although the firms of these respective partners do not perform audit services for these companies, this connection can give the appearance of receiving preferential treatments for obtaining nonaudit service engagements in these enterprises. There is a perception among stakeholders that membership of practicing auditors on the Boards of publicly traded companies and financial institutions could give rise to conflict of interest issues.

19. **The SEC has issued guidelines for auditors of publicly traded companies in Sri Lanka.** These guidelines primarily focus on issues relating to external auditors' independence. It has been proposed that auditors of publicly traded companies must be an ICASL member with a minimum of three-years, full-time, post-qualification audit experience in an audit firm. Currently, there is no requirement of such minimum years of experience for conducting SBE audits. In addition, the guidelines require rotation of audit firms or audit partners once every five years, restriction of audit and nonaudit services in certain circumstances, and disclosure of fees relating to audit and nonaudit services.

20. **The ICASL Code of Ethics is comparable with the Code of Ethics for Professional Accountants of the International Federation of Accountants (IFAC).** The Code of Professional Conduct and Ethics for ICASL members was issued in 1993. This ICASL Code was revised in 2003 in line with the IFAC Code, which was issued in November 2001. The ICASL has developed a mechanism to enforce the Code of Ethics, however their disciplinary actions appear to be light. Moreover, the cases are not made public.

21. **Two British professional accountancy bodies have branches in Sri Lanka.** The Chartered Institute of Management Accountants (CIMA), and the Association of Chartered Certified Accountants (ACCA) have a presence in Sri Lanka. This reflects the strong historical connection of Sri Lanka with the United Kingdom and the aspirations by many Sri Lankan to have internationally recognized professional qualifications. CIMA is the most active among foreign accountancy bodies operating in Sri Lanka; and more than 50 percent of CIMA and ACCA members hold concurrent membership with ICASL.

### C. Professional Education and Training

22. **It is a common practice to depend on the ICASL educational programs rather than universities for meeting academic educational requirements for entry into the accountancy profession.** The universities in Sri Lanka did not have an independent accountancy degree program until 1992 when the University of Sri Jayewardenepura (USJ) launched its bachelor's degree program in accountancy. In the recent past, some other universities followed the USJ example. In practice, the ICASL encourages students to join the ICASL-administered professional education program immediately after completion of A-level education. Although many members of ICASL have received academic degrees from universities, most of the new entrants into the profession start with an A-level academic qualification. The professional accountants who did not pursue university education generally lack adequate exposure to relevant non-accounting subjects, such as economics, management, finance and marketing.

23. **University education in accounting lacks adequate focus on practical IAS and ISA application.** The bachelor's degree program offered by the USJ was designed in collaboration with the ICASL. As a part of the four-year program of accountancy studies, undergraduates are

required to complete a two-year practical training program in selected organizations during the third and fourth years of their studies. However, the other universities offering the accountancy degree programs do not have such a provision for practical training. In general, the university accountancy curriculum does not include courses adequately covering practical IAS and ISA application. Moreover, business ethics is not being taught as a separate subject.

24. **Practical training is a prerequisite for full membership in the Institute of Chartered Accountants of Sri Lanka.** Prior to obtaining full ICASL membership, a candidate is required to have had a minimum of three-years practical training experience. The training requirements start at the intermediate level of professional studies, and the students must complete one year of training before proceeding to the final level of their professional studies.<sup>13</sup> The remaining two years of training must be completed during the final level with ICASL-approved practical training organizations. These organizations cover both audit and nonaudit sectors. However, to become a practicing auditor, the students must undertake this two years of practical training in an approved audit firm. There is no effective arrangement in place for periodic renewal of a “practicing certificate” of the auditors in public practice. There is a need for upgrading licensing procedures in line with IFAC pronouncements.

25. **The ICASL training arrangements need to be upgraded for developing skills of future accountants.** In order to adequately prepare students, ICASL training arrangements need to focus more on development in technical and functional skills, organizational and business management skills, interpersonal and communication skills, and skills in forming professional judgments. The ICASL needs to improve its capacity for providing training in line with the IFAC-proposed *International Education Standard for Professional Accountants*. The ICASL-developed training manuals for each subject should have adequate coverage on recent developments in accounting and auditing. Furthermore, ICASL should ensure that instructors have adequate knowledge of the practical aspects of IAS, ISA, and various IFAC pronouncements.

26. **There is a general perception that the overall quality of accounting education and training in Sri Lanka needs significant improvement.** In opinions expressed to the ROSC team, many stakeholders felt that the overall quality of accounting education and training in the country was not sufficient to produce skilled professional accountants and auditors. Poor communication skills in English, insufficient practical exposure, and lack of arrangements for enhancing trainee accountants’ broad based knowledge and critical thinking ability, have been identified as major contributing factors to poor quality.

27. **The Institute of Chartered Accountants of Sri Lanka issues intermediate certificates to the part-qualified accountants.** Due to the relatively low passing rate in the professional qualification examinations conducted by the ICASL, there are a significant numbers of students

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<sup>13</sup> ICASL education structure comprises four levels: foundation, intermediate, final I, and final II. The one-year training requirement at the intermediate stage is applicable for students who hold a bachelor’s degree. The students with A-level academic qualification must undergo training for two years at the intermediate stage; therefore the minimum training requirement for them is four years. The minimum training hours for each year is 1,250 hours. Trainee students are required to sign agreements with training providers and submit their training records to the ICASL for its review.

who are unable to obtain full professional accreditation.<sup>14</sup> The ICASL issues intermediate certificates to recognize these part-qualified accountants who are able to serve companies and audit firms in lower- and mid-level positions.<sup>15</sup>

28. **The ICASL curriculum does not include professional ethics as a separate subject.** The IFAC Education Committee recommends that professional ethics should be taught separately in the prequalifying education of future professional accountants.<sup>16</sup> The ICASL current curriculum does not include specific topics on professional ethics. However, in the revised curriculum, which will go into effect January 2005, only one topic on professional and ethical issues has been incorporated in the subject, Advanced Audit and Assurance.

29. **There is no mandatory requirement for continuing professional education and development.** The ICASL has developed a system of continuing professional education (CPE), although there is no mandatory compliance for its members. But there is no effective mechanism in place with regard to its enforcement as a requirement of professional membership. As a consequence, many qualified professional accountants lack up-to-date knowledge on recent developments in financial reporting, auditing, and other related subjects.

#### **D. Setting Accounting and Auditing Standards**

30. **The Institute of Chartered Accountants of Sri Lanka promulgates accounting and auditing standards.** In carrying out its legal mandate under the Sri Lanka Accounting and Auditing Standards Act, the ICASL has been involved in promulgating accounting and auditing standards since 1995. The Accounting Standards Committee and Auditing Standards Committee, the two statutory bodies created under the same Act, are responsible for assisting the ICASL in this effort. The standards are based on the application of IAS and ISA in financial reporting by specified business enterprises. Due process is followed in promulgating standards.<sup>17</sup> Based on the respective recommendations of the Accounting and Auditing Standards Committees, the ICASL Council approves the standards for adoption. The ICASL publishes the standards in the government gazette. Once published, the standards become mandatory and must be observed by the relevant practitioners.

31. **The Institute of Chartered Accountants of Sri Lanka has issued a separate accounting standard for small- and medium-size enterprises.** In April 2003, ICASL issued a

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<sup>14</sup> Yapa, P.W.S., *Empowering the Accounting Profession in Sri Lanka*, paper presented in the Second Accounting History International Conference, Osaka, Japan, August 2001.

<sup>15</sup> As of August 2003, 995 intermediate certificates were issued.

<sup>16</sup> IFAC Educational Guideline No. 10, *Professional Ethics for Accountants: The Educational Challenge and Practical Application*.

<sup>17</sup> The review of particular IAS and ISA is completed by a select group of experts from the Accounting Standards Committee and Auditing Standards Committee. The first (exposure) draft of the standard is issued for comments to different stakeholders. The standardsetting committees also organize roundtables for selected key stakeholders to comment on the draft standards. With the feedback from stakeholders, the relevant standardsetting committees again review the final draft before submission to the ICASL Council. Upon approval for adoption by the ICASL Council, the standard is published in the government gazette (for which it is translated into two local languages—Sinhala and Tamil). Generally, the ICASL Council cannot reject a standard once it is recommended by the standardsetting committees; however, the Council can ask for necessary clarification while deciding on adopting the standard.

separate standard for small- and medium-size enterprises operating in Sri Lanka.<sup>18</sup> This standard has incorporated a simplified version of accounting treatments and disclosure requirements. However, small- and medium-size enterprises are required to follow relevant Sri Lanka Accounting Standards when preparing consolidated financial statements.

32. **By 2005, the Institute of Chartered Accountants of Sri Lanka is planning to adopt all IAS and ISA.** Although there has not yet been any public commitment made, ICASL leaders have revealed in discussions with the ROSC team that they are planning to adopt all IAS and ISA in Sri Lanka by the year 2005. Considered a move in the right direction, adopting IAS and ISA without any modification would help the profession in keeping pace with the latest changes in accounting and auditing standards.

33. **Resource constraints encumber timely adoption of new standards and revision of old standards.** Currently, the Accounting Standards Committee and the Auditing Standards Committee do not have adequate full-time and professionally qualified personnel to undertake an effective standardsetting process. The members of these standardsetting committees work only on part-time basis. And these bodies suffer from serious resource constraints. These hindrances reduce timely adoption of new standards, including revisions of standards in order to reflect changes in internationally accepted accounting and auditing practices.

#### **E. Ensuring Compliance with Accounting and Auditing Standards**

34. **The Monitoring Board is constrained by lack of adequate technical expertise in reviewing SBE financial statements for ascertaining noncompliances with Sri Lanka Accounting Standards .** The Sri Lanka Accounting and Auditing Standards Act empowers the Monitoring Board to monitor the compliance with accounting and auditing standards for specified business enterprises. To ascertain the nature and extent of noncompliance, the Board reviews selected financial statements and then brings those cases requiring corrective measures to the attention of the particular enterprise. Although the Board reviews financial statements for coherence and completeness, due to its lack of sufficient technical capacity, in many cases it can not fully investigate where material noncompliances might have taken place. The Monitoring Board, with only four professionally qualified accountants, had received financial statements from 477 companies as of December 2003.<sup>19</sup> In cases of noncompliance, the Monitoring Board has been focusing on the preparers of financial statements; it has not made any attempt to deal with the relevant auditors.

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<sup>18</sup> The standard has defined certain upper and lower thresholds. The small- and medium-size enterprises fall below all upper threshold criteria and above any one within the lower thresholds. The upper thresholds include annual turnover below Rupees (LKR) 750 million, shareholders equity below LKR150 million, gross assets below LKR450 million, liabilities to banks and other financial institutions below LKR150 million, and below 1,000 employees. The lower thresholds include annual turnover in excess of LKR50 million, shareholders equity in excess of LKR100 million, gross assets in excess of LKR30 million, liabilities to banks and other financial institutions in excess of LKR10 million, and in excess of 100 employees. Although in the upper threshold criteria, the annual turnover conflicts with that of SBEs, in which case the yearly turnover is LKR500 million. small- and medium-size enterprises do not include banks, insurance companies, finance companies, stock exchanges, and publicly traded companies.

<sup>19</sup> An estimated 1,000 SBEs operate in Sri Lanka. The Monitoring Board is making an effort to ascertain the exact number and obtain their financial statements for review.

35. **The Securities and Exchange Commission has identified SLAS noncompliances for publicly traded companies.** A review of financial statements conducted by SEC staff identified disclosure deficiencies and instances of noncompliance with Sri Lanka Accounting Standards.<sup>20</sup> However, the SEC lacks sufficiently qualified professionals to conduct detailed analyses in order to fully monitor compliance with accounting and financial reporting requirements of publicly traded companies.

36. **The Bank Supervision Department of the Central Bank of Sri Lanka needs to improve its technical capacity for effectively monitoring and enforcing accounting and financial reporting requirements.** The Bank Supervision Department of Central Bank of Sri Lanka, as regulator of banking and nonbanking financial institutions, relies on bank auditors to ensure compliance with accounting and disclosure requirements. If bank inspectors identify departures from established prudential regulations, they meet with the banks and the auditors to correct the deviations. Generally, however, the Central Bank does not determine the reliability of auditors' opinions on financial statements. The Central Bank needs to improve its technical capacity to enforce the standard and to do continuous monitoring to determine the extent of noncompliance by the banks.

37. **Financial statements prepared by insurance companies need effective monitoring and enforcement actions.** The Regulation of Insurance Industry Act vested power in the Insurance Board of Sri Lanka to regulate the financial reporting of insurance companies. In practice, these powers are rarely exercised to ensure compliance with financial reporting requirements due to a lack of technical capability.

38. **The Colombo Stock Exchange does not have any monitoring and enforcing mechanism with respect to accounting and auditing standards.** The Colombo Stock Exchange is generally satisfied if a publicly traded company issues audited financial statements on a timely basis. It does not have any arrangement to monitor compliance with the financial reporting standards; also, it does not make any effort to improve the quality of financial reporting by the publicly traded companies.

39. **There is no effective mechanism for independent ICASL review of the quality assurance arrangements of audit firms.** In compliance with IFAC requirements, a country should develop and enforce quality control guidelines, requiring audit firms to put in place the policies necessary to provide reasonable assurance of conformity with professional performance standards. An independent review mechanism would ensure that audit firms have effective quality control arrangements. The ICASL has recently introduced peer review guidelines. However, it needs to develop an effective mechanism for ensuring members' compliance with established auditing standards. At present the ICASL lacks adequate proactive arrangement for monitoring and ensuring compliance with the Code of Ethics. To date, it has not taken any

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<sup>20</sup> The 2002 SEC Annual Report reported noncompliances with respect to SLAS 3, *Presentation of Financial Statements*; SLAS 5, *Inventories*; SLAS 14, *Accounting for Taxes on Income*; SLAS 16, *Retirement Benefit Costs*; SLAS 18, *Property, Plant, & Equipment*; SLAS 21, *The Effects of Changes in Foreign Exchange Rates*; SLAS 22, *Accounting for Investments*; SLAS 25, *Business Combinations*; SLAS 28, *Reporting Financial Information by Segment*; SLAS 30, *Related Party Disclosures*; SLAS 31, *Financial Reporting of Interest in Joint Ventures*; and SLAS 33, *Revenue Recognition and Disclosure in the Financial statements of Finance Companies*.

punitive measure against an auditor for Code violations or for noncompliance with auditing standards.

### III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

40. **Although mostly aligned, a gap still exists between Sri Lanka Accounting Standards and International Accounting Standards.** Although Sri Lanka Accounting Standards comply in all material respects with IAS, there exists a gap between these national and international sets of standards. This gap exists mainly for two reasons: nonadoption of certain IAS and the introduction of an alternative method that is not permitted by IAS.

41. **Some IAS have not yet been adopted by the Institute of Chartered Accountants of Sri Lanka.** Nonadoption of IAS in certain cases has raised significant differences between IAS and SLAS requirements.<sup>21</sup> For instance, SLAS 18, *Property Plant and Equipment*, does not require companies to disclose information on impaired property, plant, and equipment in line with the requirements in IAS 36, *Impairment of Assets*, which was not adopted. In another example, SLAS 22, *Accounting for Investments*, was adopted on the basis of IAS 25; however, IAS 25 was superseded by IAS 39, *Financial Instruments: Recognition and Measurement*, and IAS 40, *Investment Property*, neither of which was adopted; thus the fair value concept is not applied in SLAS 22. IAS 39 requires impairment or bad debt losses to be calculated as the difference between the assets' carrying amount and the present value of expected future cash flows discounted at the financial instrument's original effective interest rate, which may significantly vary from the current Sri Lankan practices. Due to such nonadoption, discrepancies also exist in SLAS 26, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*, with respect to accounting for investments in subsidiaries. However, ICASL is currently reviewing all these standards for adoption. With their adoption, the standard gaps will be eliminated.

42. **Some SLAS offer an alternative not allowed by the IAS.** This practice can be found in SLAS 16, *Retirement Benefit Costs*, based on IAS 19, *Employee Benefits*. IAS 19 requires an actuarial valuation for the gratuity liability calculation, whereas, parallel to actuarial valuation, SLAS 16 allows an alternative treatment of calculating the gratuity liability on the basis of a half-month salary. Therefore, actuarial valuation is not mandatory for the valuation of the liability, resulting in differences in measurement and disclosure requirement.

43. **Issuing SLAS guidelines will help preparers of financial statements to apply the standards in a uniform way.** During discussions, many stakeholders reported that many specified business enterprises, particularly the nonpublicly traded companies, have been applying established accounting standards in an inconsistent manner. The knowledge gap among the preparers and the absence of SLAS implementation guidelines often give rise to misunderstandings, creating compliance gaps between SLAS requirements and actual practices. Issuing SLAS implementation guidelines will largely help overcome this problem.

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<sup>21</sup> The ICASL so far has not adopted IAS 32, *Financial Instruments: Disclosure & Presentation*; IAS 36, *Impairment of Assets*; IAS 39, *Financial Instruments: Recognition and Measurement*; and IAS 41, *Agriculture*.

44. **Although over the years there have been improvements in the corporate financial reporting practices in Sri Lanka, there still exists evidence of “compliance gaps.”** The World Bank ROSC team reviewed 52 sets of financial statements of major publicly traded companies, including 8 banks and 5 insurance companies. Complemented by interviews with experienced corporate accountants, practicing auditors, academics, and regulators, the review findings revealed instances of compliance gaps.<sup>22</sup> While some financial statements had very high degrees of compliance, there were several instances of accounting policies and disclosures that did not comply with Sri Lanka Accounting Standards. Major noncompliances in the financial statements included the following examples:

- **Disclosures.** Many companies avoided full disclosure of information in published financial statements, ignoring the SLAS-based disclosure requirements.
- **Inventory valuation.** Some companies did not follow all requirements related to measuring and disclosing inventories at the lower of either cost or market value.
- **Segment reporting.** Some companies that apparently had business segments and geographical segments did not disclose information fulfilling the requirements of segment reporting.
- **Effects of changes in foreign exchange rates.** Some companies did not adhere to the requirement that foreign currency exchange gains or losses arising from balance sheet date revaluations should be shown in the income statement.
- **Related party transactions.** Many companies did not disclose the nature and extent of control by related parties in accordance with SLAS requirements.
- **Revenue recognition.** Some companies did not properly follow the accounting policy on revenue recognition. In case of installment sales, revenue was recognized on a cash basis rather than an accrual basis.
- **Property, plant, and equipment.** In cases where fixed assets were revalued, detailed SLAS-required disclosures were not made.
- **Employee benefits.** Some companies disclosed the existence of employee pension benefits but failed to disclose detailed SLAS-required information. In some cases, the liability for employee benefit expenses was not recognized on an accrual basis. A few companies did not disclose as to whether actuarial or any other forms of valuations had been made to quantify outstanding liabilities for employees’ post-employment benefits.
- **Pre-operating expenses.** A few companies treated pre-operational expenses as assets on the face of the balance sheet, and these capitalized expenses were written off over several years rather than expensing them when they were incurred.
- **Taxation.** Some companies did not disclose the tax effects related to the assets that have been revalued to the amount in excess of the historical costs or a previous revaluation. Furthermore, a few companies did not disclose tax losses.
- **Accounting for leases.** The finance lease valuation was not done on the basis of present value of future cash flows as required by the SLAS 19.
- **Risk exposure and loan loss provision.** Some finance companies did not present an analysis of risk exposure, maturity groupings, and adequate disclosure on loan loss provisioning.

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<sup>22</sup> Compliance gap refers to the deviation of actual practice from the applicable accounting standards.

#### IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

45. **Sri Lanka Auditing Standards are in line with the International Standards on Auditing.** Having no content differences, the ICASL-adopted auditing standards are in conformity with International Standards on Auditing. However, ISA 100, *Assurance Engagements*; ISA 240, *The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements*; ISA 260, *Communications of Audit Matters with those Charged with Governance*; ISA 505, *External Confirmations*; and ISA 545, *Auditing Fair Value Measurement and Disclosure* have not yet been adopted. The Auditing Standards Committee is actively considering these standards for review and adoption by the ICASL. Once these standards are adopted, the Sri Lanka Auditing Standards will be in full conformity with ISA.

46. **Application of auditing standards differs among audit firms of different sizes.** To assess actual auditing practices, the ROSC team interviewed practicing auditors and senior leaders of the auditing profession. Facilitated discussions were conducted with the partners representing large- and medium-size audit firms. It appeared that auditors of firms associated with the international accounting firm networks generally follow auditing standards. Nevertheless, there are instances where some of these firms appear to have taken up audit assignments merely on business considerations and thus could not ensure a proper quality audit. Smaller audit firms find it difficult to bear the cost of implementing auditing standards in an adequate fashion. Various stakeholders suggested that improved audit supervision by the audit partners and senior staff, instead of relying significantly on the trainee students, would improve the application of auditing standards.

47. **The development and dissemination of implementation guidelines will facilitate better application of auditing standards.** Most of the audit firms, except those associated with the international accounting firm networks, do not have access to quality audit practice manuals. In the absence of proper guidance, auditors generally find it difficult to deal with important concepts such as audit risks, audit planning, internal control, materiality, documentation, and going concern. This difficulty is further aggravated when the auditors do not have adequate industry-specific knowledge. Improvements in the audit quality can largely be achieved by the development and dissemination of practical guidelines on the implementation of auditing standards.

48. **There is a concern about close relationships between auditors and clients.** Many stakeholders expressed concerns about close relationship between some auditors and their clients. This may cause undue influence on auditors, resulting in noncompliance with appropriate audit procedures. It was observed that in some cases, auditors have the tendency of bringing material deficiencies to the attention of management through a management letter rather than giving qualified audit opinion.

49. **Despite arduous efforts by auditors, it is sometimes difficult to obtain appropriate audit evidences when clients lack understanding of the value of an audit.** Many auditors reported that some directors and members of top management do not understand the purpose and value of an audit. These management levels tend not to help the auditors in obtaining appropriate evidence that forms the basis of their audit opinion. There is a need for creating more awareness among investors, directors, and top management of the importance of achieving a good audit.

## V. PERCEPTION OF THE QUALITY OF FINANCIAL REPORTING

50. **There is a general perception that financial reporting practices have improved over the years; however, it is also viewed that enforcement mechanisms need strengthening to achieve improvement of quality in corporate financial reporting.** Interviews with various stakeholders, including foreign and local investors, investment bankers, financial analysts, and regulators revealed that financial reporting practices in Sri Lanka have improved over the past years. On the other hand, many have expressed concerns about the independence of many practicing auditors and the inadequacy of enforcement mechanisms. Most stakeholders agreed that in Sri Lanka many accountants are capable of producing financial statements of an international standard. The incentives to use this capacity can be strengthened by effective monitoring and enforcement mechanisms. In response to a question about the need for improving actual accounting practices in selected areas, about 85 percent of the interviewees identified related-party disclosures, segment reporting, impairment of assets, and accounting for banks and finance companies.

## VI. POLICY RECOMMENDATIONS

51. The policy recommendations presented in this section emerge from the review of accounting and auditing practices of Sri Lanka, as well as the valuable inputs received from the country stakeholders. These recommendations provide input for preparing a comprehensive country action plan geared toward a sustainable high-quality corporate financial reporting regime in Sri Lanka and are aimed at the country authorities who have authority for implementation. The priority and timing sequence of items can be determined when preparing the country action plan.

52. **Mandate the use of IAS/IFRS without modification for specified business enterprises.** There is a need for establishing an arrangement so that all Sri Lankan Accounting Standards reflect up to date changes in and additions to IAS/IFRS and related interpretations issued by the International Accounting Standards Committee. These standards should be legally mandatory for all specified business enterprises. The Accounting Standards Committee should continue its current efforts on issuance of simplified financial reporting standards for small- and medium-size enterprises. The ICASL should make arrangements through the Accounting Standards Committee and the Auditing Standards Committee for issuing standards implementation guidance, for which both committees should have adequate technical capacity in place. These recommendations would ensure uniform application of standards and facilitate the improvement of compliance practices.

53. **Make cohesive efforts for strengthening the enforcement mechanism.** High-quality corporate financial reporting depends on effective enforcement mechanisms. Merely adopting international accounting and auditing standards is not enough. Three important links exist in the enforcement sequence: (a) directors and top management must ensure that financial statements are prepared in compliance with established standards; (b) auditors must act independently and judiciously to ensure that financial statements comply with applicable accounting standards and represent a true and fair position of the enterprise's financial condition; and (c) regulators, both self-regulatory organizations and statutory regulators, must implement arrangements for efficient monitoring of regulatory compliance and consistently take appropriate actions against violators.

The enforcement mechanism must stress the regulators' transparent and unbiased decisionmaking, quick and confidential investigative process, and effective means for rectifying detected noncompliances, together with imposing appropriate sanctions.

54. **Strengthen the capacity of the Monitoring Board and other regulators.** Ineffective regulatory regimes provide a false sense of security to stakeholders, which is why it is important to strengthen the capacity of the Sri Lanka Accounting and Auditing Standards Monitoring Board. Capacity building of the Monitoring Boards should focus on technically qualified personnel, practical training of inspectors/reviewers, administrative support, and necessary logistics arrangements. With improved capacity the Monitoring Board would be well prepared to conduct reviews of financial statements plus independent practice reviews of audit firms. Also, it is recommended that the Securities and Exchange Commission, Central Bank of Sri Lanka, and Insurance Board of Sri Lanka actively recruit experienced individuals to effectively deal with accounting and financial reporting-related issues involved in the supervision of regulated entities. It is necessary to establish proper incentives for attracting well-trained and top-quality personnel in all regulatory bodies.

55. **Ensure better coordination among regulatory bodies for improving compliance practices.** The regulatory bodies in Sri Lanka need better coordination in order to function cohesively and together ensure sustainable, high-quality corporate financial reporting. The Monitoring Board should continue ensuring compliance while the other regulatory bodies complement these efforts by quickly alerting the Monitoring Board to noncompliance issues. A memorandum of understanding signed between the Monitoring Board and the Securities and Exchange Commission is a good first step toward a coordinated system among all regulatory bodies for monitoring and enforcing the compliance of accounting and auditing standards.

56. **Initiate legal reforms for improving compliance with accounting and auditing standards.** The legal reforms should focus on the following:

- ***Sri Lanka Accounting and Auditing Standards Act.*** This Act should clearly set out the jurisdiction of the Monitoring Board over the practicing auditors by clarifying some sections of the Act and adding provisions on specific sanctions for various types of noncompliance. The Monitoring Board should be given comprehensive power for imposing appropriate administrative sanctions against infractions of standards and relevant rules and regulations. Introducing administrative sanctions, in many cases, will help regulators act quickly and effectively against noncompliances, instead of resorting to long and complicated legal process. Revision of the Act should include measures for strengthening the governance of the Monitoring Board and giving it a specific legal mandate for independent oversight of the audit profession. This may be done by including nonpracticing accountants and recognized professionals in the field of accounting, finance, banking, and insurance on the Board, thus broadening management of the Monitoring Board. In addition, the Board should be given adequate resources and authority to recruit higher level staff at an adequate remuneration.

57. **Introduce a system of independent oversight of audit profession by the Monitoring Board.** There appears to be a clear need for balancing self-regulatory arrangements with a system of independent oversight of audit functions. Parallel to the self-regulation by ICASL, the

Monitoring Board, in association with other regulators, should undertake the independent oversight function focusing on the following:

- Defining requirements for eligibility of firms, in consultation with ICASL, for undertaking audit assignments of specified business enterprises. While defining these requirements, the proposed SEC guidelines may be considered.
- Monitoring the performance of practicing auditors which may include (a) on-site review of audit firms with regard to compliance with auditing standards and other applicable requirements, including code of ethics; (b) preventive measures for ensuring that audit firms have adequate quality assurance arrangements; and (c) adequate investigation and disciplinary proceedings, along with imposition of appropriate sanctions. The monitoring should be based on a robust methodology drawing on international best practices.

58. **Take steps for wider public availability of review results and follow-on enforcement actions to help augment a culture of compliance.** Currently, the Monitoring Board has arrangements to publish on its website cases of noncompliance. Given the country's social and cultural underpinnings, many experienced stakeholders believe that wider public disclosure of the results of monitoring and enforcement actions through print and electronic media will act as incentives both for preparers and auditors to abide by standards, rules, and regulations. Such public reporting will bolster a culture of compliance.

59. **Introduce an awareness program for improving the degree of compliance with accounting requirements by specified business enterprises.** The ICASL and the Monitoring Board should work jointly to design an awareness program on the importance of compliance with accounting and auditing requirements. Shareholders and top SBE management should be briefed on their responsibility regarding compliance with standards and on enforcement policies. These programs should include case studies demonstrating strengths and weaknesses of financial reporting in the Sri Lanka, emerging international developments, and the role of transparent financial reporting in attracting both strategic and portfolio foreign investments.

60. **Upgrade the licensing procedures for accountants and auditors in public practice.** The ICASL should streamline its licensing procedure for accountants and practicing auditors in conformity with IFAC guidelines. The curriculum and system of qualification examinations should be improved to conform to the IFAC-issued *International Education Standard for Professional Accountants*. In particular, ICASL should develop a sound mechanism for renewing practice license of the auditors in public practice on the basis of their performance evaluation.

61. **Require separate disclosure of audit and nonaudit service fees.** Currently, the audit fees are disclosed in the financial statements. It is perceived that auditors supplement the low audit fees with relatively higher fees for nonaudit services in the same enterprise. To ensure transparency, it is recommended that arrangements should be in place to disclose the amount of audit and nonaudit service fees separately. In this regard, the proposed SEC guidelines may be considered.

62. **Strengthen the capacity of the Institute of Chartered Accountants of Sri Lanka.** The ICASL capacity needs to be strengthened to ensure its effective role in meeting IFAC

membership obligations. Capacity can be improved through building a full-time team comprising technically qualified professionals to discharge administrative and professional responsibilities under the close supervision of the ICASL Council. The Council should include nonmembers to ensure wider accountability and increased credibility of the profession.

**63. Improve the professional education and training arrangements of the Institute of Chartered Accountants of Sri Lanka.** The ICASL should improve its instruction manuals to make them compatible with international learning materials for trainee accountants. Emerging global developments in accounting and auditing must be incorporated in the ICASL training curriculum. Business ethics should be taught as a separate subject. The ICASL should employ instructors with training in and knowledge of the practical dimensions of accounting and auditing standards.

**64. Improve academic accounting curriculum and teaching.** In order to ensure a minimum quality standard is maintained in teaching accounting and auditing courses in all Sri Lankan universities, an initiative is necessary for curriculum development and training-the-trainers activities. The academic curriculum should be updated with recent developments in the field of accounting and auditing, and teaching should focus on international components and practical implementation aspects of accounting and auditing standards. Business ethics should be taught as a separate subject in all universities offering accounting degree programs. Adequate attention should be given to teaching corporate finance, English, and communication skills; and developing the critical thinking ability of students.

**65. Introduce continuing professional education as a mandatory requirement for all qualified accountants.** The requirements on continuing professional education and development of the qualified members should be made mandatory in line with the IFAC-issued *Continuing Professional Education and Development—Proposed International Education Guideline for Professional Accountants*. The ICASL should arrange delivery of high-quality training programs on practical implementation aspects of accounting and auditing standards, and the code of ethics for professional accountants. It should also facilitate access to programs offered by universities and other training providers so that its members can meet the requirements for continuing professional education and development. The ICASL should develop a mechanism for monitoring and enforcement of the requirements on continuing professional education of the practicing members.