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UNLAWFUL PRIVATIZATION IN SRI LANKA: THE ROLE OF THE AUDITORS

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Background

The principal assets of an auditing firm and of chartered accountants are their reputations and their integrity. It is a firm's reputation for accuracy and independence that makes it valuable to governments, investors and the public. In the sale of the Sri Lanka Insurance Company (SLIC), a privatization transaction nullified by the Supreme Court of Sri Lanka on June 4, 2009 for unlawfulness and misconduct, two auditing firms – PriceWaterhouseCoopers (PWC) and Ernst & Young – forfeited their reputations. Both firms lent their expertise to a transaction that illicitly converted a public asset into private wealth for unscrupulous individuals/organizations. The privatization of SLIC was a transaction that took place on two parallel tracks: one occurred before the public and the other transpired behind the scenes, orchestrated by politicians, auditors and private firms seeking to benefit at the public's expense. Documents are now available that illustrate clearly, with dates, names and amounts of money, the invisible and illicit manipulations behind this privatization transaction, together with the pivotal role played by the two chartered accounting firms as they betrayed the public trust and duty of professional care.[1] Much of the information recounted here is cited in the written submission of Nihal Sri Ameresekere[2] to the Supreme Court of the Democratic Socialist Republic of Sri Lanka, in the matter of SC (FR) Application 158/2007 of an Application under Article 126 of the National Constitution, Vasudeva Nanayakkara (Petitioner) vs. 28 Respondents.

Unauthorized Preparation for the Sale of SLIC

The privatization of a public enterprise in Sri Lanka requires the approval of the Cabinet of Ministers even to begin. Nevertheless, just before July 20, 2001 the Public Enterprise Reform Committee (PERC), on its own initiative, drafted a concept paper that set out a plan to privatize SLIC. Based on this paper, the Chairman of the PERC, P.B. Jayasundera, formed a Core Group to consider the transaction. From time to time, Jayasudera had served as a senior policy advisor to Ernst & Young, the auditors of SLIC, who should have been independent of the PERC and, consequently, of Jayasundera. The Core Group consisted of five people, including the Chairman of SLIC, and one Deva Rodrigo, Senior Partner, PriceWaterhouseCoopers. This group was to deliver a recommendation about the sale to Jayasundera, the chairman of the PERC.[i] It should be

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[1] Much of the information recounted here is cited in the written submission to the Supreme Court of the Democratic Socialist Republic of Sri Lanka, in the matter of SC (FR) Application 158/2007 of an Application under Article 126 of the National Constitution, Vasudeva Nanayakkara (Petitioner) vs. 28 Respondents.

[2] Mr. Ameresekere is a Fellow Member of the Institute of Chartered Accountants of Sri Lanka *(FCA)*; - Fellow Member of the Institute Chartered Management of UK *(FCMA)*; Member of the Association of Certified Fraud Examiners of US *(CFE)*. Information about him and about this case can be found at www.consultants21.com

noted that the appointment of the Chairman of SLIC as the Chairman of the Core Group is precluded by public finance regulation.[3]

On September 3, 2001, the Core Group delivered its conclusions to Jayasundera, in his capacity as Chairman of the PERC, recommending the privatization of SLIC. On January 21st, 2002, Minister Milinda Moragoda, who was the Minister in charge of PERC, appointed a Steering Committee to oversee the transaction. The Steering Committee also included the Chairman of SLIC, Jayasundera himself, and Rodrigo of PriceWaterhouseCoopers. Rodrigo, therefore, was a member of the Core Group, the Steering Committee, and the consulting firm ultimately involved in the privatization of a valuable public asset: SLIC.

The Minister of Economic Reforms, Milinda Moragoda, as a member of the Cabinet, was responsible for reporting on the activities of his ministry and the PERC to the Cabinet as a whole. Nevertheless, it was not until he had *received* the Steering Committee recommendation, that Moragoda submitted a memorandum to the Cabinet notifying the ministers that he had *appointed* a Steering Committee to advise and assist in restructuring SLIC. Approximately one month later, Moragoda notified the Cabinet that he was seeking approval of a proposal to appoint international advisors to conduct an independent valuation of SLIC and restate the accounts of SLIC according to international accounting standards. Moragoda also sought to authorize SLIC to meet payments in connection with these financial services in an amount not to exceed US$2 million, and to authorize the government to pay a success fee to the financial advisors retained. On the same occasion, Moragoda requested authority to instruct the Steering Committee to request proposals from companies seeking to provide financial advisory services in connection with the privatization transaction. These proposals were to be evaluated by a Technical Evaluation Committee (TEC);[ii] the Steering Committee had already called for Proposals from five selected companies.

In the same Cabinet Memorandum, Minister Moragoda also sought approval to appoint a Tender Board and Technical Evaluation Committee (TEC) to evaluate the bids to purchase the shares of SLIC. Cabinet responded positively, but insisted that the Tender Board be appointed by the Cabinet itself. In addition, the Ministers requested that Moragoda report the feasibility of retaining a minority share in SLIC by the government.[iii] Documents made public in the Supreme Court case, however, conclusively show that the Steering Committee had already proceeded in another direction: Jayasundera himself initiated the appointment of the Tender Board and, contrary to the Cabinet decision, a Tender Board was appointed by N. Pathmanathan, Deputy Secretary to Treasury. For its part, the Steering Committee was structuring the sale of 90% of the shares of SLIC. The remaining 10% were to be offered to employees of the company. The government – and thus the public – would retain nothing.[iv]

Court documents also show that Ernst & Young, the auditors of SLIC, had cooperated from the very beginning in the accounting work required to move ahead with the divestiture without Cabinet approval. Records reveal that Ernst & Young had quoted a fee of US$ 81,000 to restate the SLIC Audited Accounts on the basis of International Accounting Standards. According to the documents, Cabinet did not authorize any restructuring of SLIC until April 3, 2002. Prior to this

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[3] Court documents show that this appointment was in violation of Public Finance Circular No. 352, August 24, 2000.

date, the Steering Committee had already called for bids to provide the financial services necessary for privatization, had evaluated the bids and had shortlisted PWC. It is not surprising that PWC was shortlisted; Rodrigo was on the Steering Committee and the Core Group and was fully informed about the amount the government was prepared to pay for financial services. In other words, a PWC partner was an adviser to both the contractor and the potential contractee in this transaction. Ernst & Young was also shortlisted and this firm, too, held privileged information from both sides of the transaction. In other words, both firms should have been disqualified because of their access to the accounts of SLIC and the funding parameters of the contract, but they were not.

PWC subsequently signed a contract with the government for a tax-free total of $1,065,000.[v] While the contract was signed by PWC Indonesia, court documents and public announcements concerning the sale of shares in SLIC show that PWC Sri Lanka acted jointly with the company's Indonesia franchise and provided key personnel to the project.[vi] A PERC internal audit report prepared by SJMS Associates, Chartered Accountants, read: "Mr. Deva Rodrigo, partner of PWC, was one of the members of the Steering Committee that selected PWC as the financial advisor; the conflict of interest was not considered."[vii]

The entire privatization process was *de facto* well down the road, manipulated by Moragoda and Jayasundera, with assistance from PWC and Ernst & Young, by the time the official bodies – the Cabinet and the Technical Evaluation Committee – were even informed, much less involved. By July 9, 2002, in fact, the PERC had already placed advertisements in the international media calling for expressions of interest in the proposed sale of up to 90% of the shares of SLIC. At this point, as far as the public was aware, Cabinet was still considering retaining a minority stake in the company, and a Cabinet Approved Tender Board (CATB) had not yet been appointed.

Expressions of Interest, however, were placed in only two international media outlets. The announcements instructed those interested to submit EOIs by mail or fax to PWC Indonesia and PWC Sri Lanka.[viii] The TEC had not approved either advertisement. According to regulation, EOIs are to include the details of the bidding companies' ownership structure and profile, audited financial statements for the previous three years, and relevant operational capabilities. This information is, of course, required in order that the evaluation committee may establish the capabilities and *bona fides* of the bidders. Proposals are to be deposited before a specified time and date in a sealed box and opened in public. Instructing bidders to submit proposals directly to PWC was a serious violation of practice and procedure, leading to, at the very least, a lack of transparency in the handling of the bids. In effect, this step shows that once the reputation of PWC was put at the service of an irregular process, the subsequent steps necessary to complete the illicit divestiture of SLIC fell into place.

An Irregular and Unlawful Sale Process: Beneficiary Owners of SLIC Unknown

By the specified deadline for submissions, August 23, 2002, PWC had received 17 EOIs. Distilleries Company of Sri Lanka, Ltd. or Distilleries Consortium, the enterprise that submitted the successful final bid, was not one of them. Nor had Distilleries submitted a technical proposal

by the deadline of September 17, 2002. It was not until November 29 that one of the companies selected to submit a final bid actually produced, for the first time, a technical and financial proposal on behalf of Distilleries Company of Sri Lanka, Ltd. Jayasundera justified this late stage proposal in his affidavit five years later to the court when the particulars of the privatization transaction were being examined:

> The final bidding process could provide for well credentialed financial/insurance parties to join the process – and leave open the possibility for new parties, who have not submitted EOIs, of possibly joining with parties who had submitted EOIs.

This affidavit is clearly a reference to Distilleries Company of Sri Lanka, which was the only party added to the list of final bidders that had not been previously approved. Informed observers now point out that if new parties were to be admitted to the bidding process, then the opportunity should not have been known only to a few. Since the intention was to attract international bidders to this process, in the interests of the government and the public, the amplification of procedures should have been made known publicly, worldwide. Moreover, a memorandum written for Cabinet on March 27, 2003, suppresses the names of the 17 parties who originally bid in compliance with deadlines and guidelines and lists only five parties as final bidders, one of which has now become Distilleries. Allowing un-vetted bidders to enter the competition through the 'back door' was in violation of government Tender Guidelines and Procedures.[ix] Ironically, Jayasundera himself was responsible for drafting the circular setting out these guidelines, when he was Secretary to the Treasury and Secretary for the Ministry of Finance and Planning.

The sale process became even murkier and complex in the following days. On April 2, 2003 Cabinet approved a memorandum written on March 27th, 2003, giving its approval to the Secretary to the Treasury to execute the "Share Sale and Purchase Agreement" to divest 90% shares of SLIC to the Distilleries Consortium. In violation of this order, the Acting Secretary to the Treasury signed the agreement with two other companies as purchasers, namely Milford Holdings (Pvt) Ltd., and Greenfield Pacific EM Holdings Ltd., Gibraltar, both of which had been incorporated after the Cabinet's memorandum approving the sale of SLIC shares to Distilleries had been written. In fact, neither of the purchasers had been in existence when Moragoda submitted to Cabinet the memorandum seeking approval for the sale and purchase agreement with Distilleries. That said, neither holding company could have been evaluated for details of ownership, financial statements and operational capabilities. They were both "parachuting parties," who entered the bidding without being evaluated either for solvency, legality or capability as any company seeking to own and operate a crucial public service, such as insurance, should have been.

Additional documentation establishes that the beneficial owners of Greenfield Pacific EM holdings Ltd., Inc. in Gibraltar are unknown. This entity is solely owned by Hambros Ltd. (Gibraltar Nominees), which is owned by SG Hambros Bank (Gibraltar) Ltd., which is in turn owned by SG Hambros Bank, UK. The annual report of SG Hambros Bank, Ltd. UK discloses that the principal business activity of the bank is the provision of "trust structures." In short, the government had sold SLIC to a private entity, the beneficial owners of which were unknown. If nothing else this transaction is in violation of Article 52 of the UN Convention against Corruption, which states that governments are to:

Take reasonable steps to determine the identity of beneficial owners of funds deposited into high-value accounts and conduct enhanced scrutiny of accounts sought or maintained by or on behalf of individuals who are, or have been, entrusted with prominent public functions and their family members and close associates.[x]

In response to the terms of the Convention, Sri Lanka has established a financial intelligence unit (FIU) at the Central Bank. To date, however, the FIU has not been requested to determine whether the beneficial owners of the entities that purchased SLIC are close associates of those 'with prominent public functions.' At the same time, Milford Holdings is presently and indirectly owned by Distilleries Company of Sri Lanka Ltd. and Stassen Exports Ltd., which like Greenfield Pacific, were unevaluated by the TEC or Tender Board.

Undervaluing SLIC: Manipulation of Accounts

When the Share and Sale Purchase Agreement was signed it included a provision to adjust the 'purchase consideration' according to differences in SLIC accounts updated by Ernst & Young from March 31, 2002 to April 11, 2003:

ADJUSTMENT OF CONSIDERATION

(A) The Consideration shall be adjusted following First Completion as follows:
(i) if the Net Working Capital is higher than the amount shown in management accounts, by adding the amount by which Net Working Capital exceeds that amount; and.
(ii) if the Net Working Capital is less than the amount shown in the management accounts, by deducting the amount by which Net Working Capital is less than the amount.
(B) if as a result of such adjustment:
(i), the amount of the Consideration is increased: the Purchasers shall pay to the seller in cash, a sum equal to that increase; or.
(ii) the amount of the Consideration is reduced, the Seller shall pay to the Purchasers in cash, a sum equal to that reduction.

Steering committee minutes make clear that the intention was to compute the purchase price adjustment on the basis of a comparison of audited accounts for SLIC on March 31, 2002 and April 11, 2003. International accounting standards required Ernst & Young to restate the current assets and current liabilities of SLIC on the two dates based on independently audited accounts. In fact, Ernst & Young failed to compute the purchase price adjustment before handing over absolute possession and management of SLIC to the purchasers on April 11, 2003. This decision, taken unilaterally with no safeguard in place to protect the interests of the government, led to the non-conclusion of this transaction and opened the door to a demand from the purchasers for a refund from the government of Rs.2.1 billion.

At some point in the proceedings, Ernst & Young surreptitiously and retrospectively reclassified the working capital of SLIC in such a way that it appeared that the government owed a substantial sum to the Purchaser after the transfer of ownership on April 11, 2003. Documents available strongly suggest that the reclassification of Net Working Capital occurred after the "freeze letter" dated October 9, 2002 sent by the PERC to SLIC. This letter is routinely sent during a divestiture process to prevent changes that would have a material impact on the evaluation and price of the enterprise being privatized.[4]

Documents before Court reveal that the PERC in 2004 had questioned Ernst & Young about this retrospective and surreptitious reclassification of the SLIC investment portfolio by Rs. 3,000 Mn. but had not received any explanation from Ernst & Young. Documents also show that the normal Annual Audited Accounts of SLIC audited by Ernst & Young as of December 31, 2001 and December 31, 2002 presented the current assets and current liabilities separately on the balance sheet. Consequently, it is not clear why these classifications had been omitted in the un-audited accounts of SLIC as of the relevant dates March 31, 2002 and April 11, 2003 signed by Ernst & Young. When queried about this discrepancy, Ernst & Young requested and obtained 17 extensions to compute the increase in the net working capital of SLIC and adjust the purchase consideration. In the end, however, Ernst & Young simply did not ever produce the calculations requested, although the firm was obliged to do so.

In effect, it is clear that Ernst & Young was working from un-audited accounts produced by management. This is an extremely uncommon practice,[5] and the auditors should have refused to carry out the assignment based on unverified figures.

The conduct of Milford Holdings since the Supreme Court's voiding of the sale shows an awareness of the dimensions of this manipulation of accounts by its perpetrators. Whereas initially Milford Holdings had sent the government a letter of demand, contending that it had paid too much for SLIC, the company subsequently reversed its position radically. In the face of disclosures made in Court, Milford Holdings pleaded with the Supreme Court not to annul the transaction. In order to maintain ownership of SLIC, Milford offered to withdraw its demand for a refund from the government in the amount of Rs. 2.1 billion based on its claim that it paid too much, and increase the amount it paid for its shares, acknowledging that the unadjusted purchase price was too low.

At the same time, Ernst & Young, the firm responsible for the retrospective reclassification of assets, has gone silent when questioned about the motive and rationale for the purchase price adjustment. Moreover, Ernst & Young has been unable to confirm that SLIC accounts were prepared in compliance with international accounting standards. Similarly, PWC, which structured the transaction and charged exorbitant fees for doing so, has evaded requests to clarify the issue of the purchase price adjustment. As consultants to the government,

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[4] See Correspondence from Nihal Sri Amereseke, F.C.A; F.C.M.A. and F. H Puvimanasinghe, Chair, Panel of Ethics Committee, Institute of Chartered Accountants of Sri Lanka., posted at http://www.consultants21.com/

[5] Generally, reputable auditors do not produce valuations based on draft/management figures that have not been independently verified. An auditor is called upon to give information and not "means to information." Taking all factors into account, the special circumstances, the parties involved (including the Government), and the major sums of money at issue, it would have been both prudent and ethical for the Ernst & Young auditors to have refused to work on draft accounts.

PriceWaterhouseCoopers had a responsibility to protect the interests of the Treasury and the public. The administration of the PERC that succeeded Jayasundera attempted to clarify the transaction orchestrated by him in favor of offshore holding companies but has received no cooperation from either Ernst & Young or PWC. Apparently, the two auditing firms were working in collusion with the purchasers' consortium, although they were paid by the government to represent the sellers and the public of Sri Lanka. Ernst & Young, as Auditors of SLIC – wholly-owned by the government until April 11, 2003 – owed a professional duty of care to the government. Instead, it appears the firm collaborated with the new purchasers of SLIC, even to the point of adjusting SLIC accounts in favor of the purchasers during the period of government ownership.

The conclusion that the auditors collaborated with the illicit purchasers of SLIC is based on numerous discrepancies in the company's accounts, particularly in the structuring of the deal. The terms of purchase permitted a net working capital adjustment of the sale price that could not be concluded during the period allowed. All of this disadvantaged the government. In another adjustment, certified by PWC, auditors restated the calculation of SLIC's net profit before tax for the year 2001, lowering the figure to approximately 20% of the value previously assigned. Having erroneously restated (and dramatically reduced) the company's profits for 2001, PWC then projected this diminished value for the next five years. Subsequently in court, the PWC valuation was shown to be grossly erroneous, and the Supreme Court annexed to the Judgment the valuation done by one of the Respondents, the Chairman of PERC who succeed Jayasundera According to court documents, this 'discounted cash flow valuation,' of PWC together with other accounting manipulations lowered the value of SLIC from approximately Rs. 22 billion to about Rs. 5.2 billion.

In addition, PWC based its valuation of SLIC on the book value of net tangible assets taken from a balance sheet rather than on the market value of these assets, which was substantially higher. As a result, SLIC's balance sheet showed the company's fixed assets had a value of only Rs. 329.3 million on January 31, 2001. Two years later, however, a Cabinet memorandum, dated March 27, 2003 read as follows: "SLIC recorded a turnover of Rs. 7.8 billion, with a profit after tax of Rs. 753 million and has net assets of around Rs. 5.7 billion after revaluation of fixed assets for the financial year ending 1 December 2002 as per the unaudited draft accounts."

In addition, total liabilities were misleadingly overestimated and the brand value of SLIC, a well-established and profitable insurance corporation in Sri Lanka, was not included in the valuation. In total, it appears that the evaluation of SLIC calculated by PWC was less than 20% of the true value of the company.[6]

Conflicts of Interest

[6] A valuation based on actual net assets, an adjustment for market value of fixed assets, an adjustment for market value of investments, with an added 150% of general insurance premiums from 2002, plus one year's revenue from life insurance premiums for 2002 totals over Rs. 22 billion. This figure is to be contrasted with PWC's valuation of just over Rs. 5 billion (SC FR Application No. 158/2007).

None of the above manipulations would have been possible if this transaction had been carried out transparently by government officials and auditors, who truly represented the interests of the public. Most importantly, Deva Rodrigo, a senior partner of PWC, was also a member of the Steering Committee that selected PWC as consultants on the transaction. He supervised their work and authorized payments to them while he simultaneously worked for them himself and enjoyed a share of such fees as a Senior Partner, PWC Sri Lanka.

As a firm, Ernst & Young, too, had a conflict of interest. The firm continued to be the auditors of SLIC after the purchasers took possession, management and control on April 11, 2003. At the same time, Ernst & Young was committed to audit SLIC accounts on December 31, 2002 and April 11, 2003 for the government, i.e., the sellers. As the court documents read in SC FR Application No.158/2007:

> In the context of the conduct and actions of Ernst & Young, Hon. Attorney General, by letters dated 9.2.2005 had put Ernst & Young on notice of negligence, and had forwarded further letter dated 11.2.2005 to Ernst & Young, putting them on notice of legal action for negligent acts or willful misconduct and wrongful conduct.

Because of its representation on the Steering Committee, PWC was aware of the misconduct of Ernst & Young. As consultants to the government, PWC had failed to discharge its duties, due diligence and responsibility to protect the interests of the government, the client of PWC. When questioned by the PERC under a succeeding administration by letter dated November 17, 2004 about the retrospective reclassification of SLIC investments on December 31, 2001, PWC failed to provide an explanation. Moreover, PWC failed to ensure that SLIC accounts were audited in accordance with international accounting standards. If PWC were going to attract an international investor for the purchase of shares of SLIC, then PWC itself would need to guarantee that SLIC's accounts were audited correctly by Ernst & Young.

In addition, PWC engaged Aneela de Soysa as a partner one month before the signing of the Share Sale and Purchase Agreement of SLIC on April 11, 2003. De Soysa had been the 'Transaction Manager' for the PERC and Secretary of the Steering Committee. Notwithstanding this conflict of interest, Aneela de Soysa continued to represent PWC in dealing with the PERC on SLIC transaction.

PB Jayasundera, Secretary, Ministry of Finance and Secretary to the Treasury, had also served as a senior policy adviser to Ernst & Young. This auditing firm had been given several lucrative consultancy assignments on privatizations by PERC while Jayasundera was chairman of the PERC/Secretary to the Treasury. For a period of years, until the Supreme Court's decision, there has been a serious dispute between the government and Ernst & Young regarding the sale of SLIC. Action by the government against Ernst & Young had to be taken by Jayasundera himself as the Secretary to the Treasury. Although he had been advised to take action by the country's Attorney General, he did not do so.

These conflicts of interest were not immaterial. When the government changed and the officials who had structured the privatization of SLIC left the PERC, the subsequent administration attempted to clarify the details of the transaction. Neither Ernst & Young nor

PriceWaterhouseCoopers were cooperative. When the new officials requested in writing figures related to this transaction, particularly to the purchase price adjustment, neither accounting firm responded. This failure to clarify work done for the government as a client does not comply with the standards for professional conduct for both auditors and accountants. The Attorney General had put both firms Ernst & Young and PWC on notice for professional negligence and misconduct, which Jayasundera failed to pursue.

Inaction From The Institute of Chartered Accountants Sri Lanka

The professional association setting out regulations and standards of professional conduct for chartered accountants in Sri Lanka is the Institute of Chartered Accountants of Sri Lanka (ICASL). The Institute is quasi-statutory body to which the government grants funds and appoints nominees, and as such, it has a legal obligation to pursue allegations of misconduct and fraud. As long ago as August, 2005 the ICASL had received a complaint about the misconduct of Ernst & Young and PWC in the privatization of SLIC.

Subsequently in April 2006, Nihal Sri Ameresekere, Jayasundera's successor as Chairman PERC, gave evidence before a four-member ethics panel of the ICASL. Two members of the Panel, including the Chairman, found that there were prima facie cases against both Ernst & Young and PWC in SLIC privatization. In the aftermath of this decision, the conduct of the two dissenting panel members was suspect. One member, who had signed the decision, dissented later, and the other, who disagreed with the decision, had attended very few meetings of the panel. Neither of the two dissenting members ever explained to the public or to the ICASL the logic behind their disagreement. Consequently, the findings of the four-man panel were submitted to the ten-member Ethics Committee of the ICASL, which decided that prima facie cases of professional misconduct by both Ernst & Young and PWC did exist.[xi]

When the Ethics Committee reports a prima facie case of misconduct against a member of the Institute, the Council of the ICASL is required to appoint a Disciplinary Committee for the purpose of conducting an inquiry.[xii] Nonetheless, it is apparent that ICASL failed to take the action that it should have as long ago as August, 2005. Three years later, in the face of disclosures made at the Supreme Court, the ICASL did form a disciplinary committee to inquire into the professional misconduct of PWC, but not Ernst & Young. As auditors of SLIC, however, Ernst & Young had a greater obligation and responsibility to the government. It is now being argued before the court that the failure to investigate the conduct of Ernst & Young in SLIC transaction represents a serious breach of professional duty and fiduciary responsibility by the Institute Chartered Accountant of Sri Lanka. In fact in the SLIC Judgment, the Supreme Court had ordered 'forthwith' the removal of Ernst & Young as Auditors of SLIC. Further, the Supreme Court, in a consequential order, directed that an audit of the SLIC accounts be redone by the Auditor General for the entire period of April 11, 2003 until June 4, 2009, the date on which SLIC reverted to the government.[xiii]

The indifference and inaction of the ICASL to a complaint made by a member of the public over four years ago continued, even after a damning report from Parliament was issued in January

2007. This report criticized both Ernst & Young and PWC and exposed serious problems of conflict of interest.

The Report of the Committee on Public Enterprises to Parliament

In January 2007, the Committee on Public Enterprises (COPE) submitted a report to the Parliament examining the relevant documents, facts and individuals concerned in the privatization of the Sri Lanka Insurance Corporation. In their report, the members of the Committee singled out Jayasundera for special mention and criticism. With respect to Ernst & Young and PWC, COPE's findings were quite specific:

- The Cabinet had rejected the request of the Secretary to the Treasury to appoint a Tender Board and decided that the Tender Board would be appointed by the Cabinet;
- After the evaluation of bids, the Technical Evaluation Committee recommended the sale of 90% of the shares in SLIC to the consortium made up of Distilleries Co. Ltd., Aitken Spence Co. Ltd., Aitken Spence Insurance (Pvt) Ltd., together with Technical Parties, ING Institutional and Government of Advisory Services BV (Holland) on March 25 2003;
- The April 11, 2003 Share Sale and Purchase Agreement was signed with Milford Holdings (Pvt) Ltd., and offshore company Greenfield Pacific EM Holdings Ltd., incorporated in Gibraltar on March 28, 2003. Neither company was in existence when the Cabinet approved the sale on March 27 2003;
- Neither company was a bidder and "they were strangers;"
- The sale took place based on un-audited accounts and therefore it was not possible to enter into any kind of share transaction. It also appeared the accounts of SLIC had been surreptitiously and intentionally adjusted to diminish its share sale price artificially;
- Ernst & Young auditors and PWC consultants were directly involved in fraudulent conduct;
- Ernst & Young, which had been auditors of SLIC while the government was a 100% shareholder, continued as SLIC auditors after the sale to the illegal buyers and had been compromised by them not to discharge their responsibilities to the government;
- The Chairman of the PERC, who managed SLIC transaction and later became Secretary to the Treasury, P.B. Jayasundera, has been a senior policy adviser to Ernst & Young, and had failed to act in the interest of the government in this matter;
- Prima facie the conduct of the responsible officers is in violation of the provisions of the Public Property Act and the Bribery and Corruption laws.[xiv]

Even in the wake of this report the ICASL failed to convene a disciplinary committee for the purpose of investigating Ernst & Young, and the inquiry into the professional actions of PWC is not proceeding. On June 15, 2009, therefore, Vasudeva Nanayakkara, the legal petitioner in SLIC case resolved and reversed by the Supreme Court, wrote through his attorney to the President of the ICASL. Referring to the implications of this Judgment, the letter read in part:

> The Judgment also draws attention to the fact that several allegations have been made against several persons in connection with the above wrongful, unlawful, illegal and fraudulent acts, but that the Supreme Court had stated that it had confined itself to executive and administrative actions, coming within the purview of fundamental rights jurisdiction of the Supreme Court. Your kind attention is drawn to the conduct and actions of two member firms of your Institute in the perpetration of this said wrongful, unlawful, illegal and fraudulent acts, namely, Ernst & Young and PriceWaterhouseCoopers, who were also as you are aware, respondents in the said case....
>
> Our client requires you, as warranted, to forthwith carry out investigations in terms of the said statutes, and to take action and/or cause action to be taken against those who have committed offenses thereunder, irrespective of their sociopolitical and/or socioeconomic standing and/or status, since as you are aware, no one is above the "rule of law."[xv]

It is noteworthy that this letter was written five years after the transaction took place, four years after the first complaint about it, and over three months after the Supreme Court judgment nullifying it.

Nearly six weeks later, the complainant, Amrit Muttukumaru, also wrote to the ICASL, expressing his concern about the lack of action in the inquiry involving PWC and Ernst & Young. In his letter he accused the ICASL of "disgraceful handling of its investigation," and pointed out the close links between PWC and the ICASL. This letter elicited only the briefest of responses from the Institute:

> I refer to your e-mail communication to the president of the Institute of Chartered Accountants of Sri Lanka dated 29 July 2009 regarding the matter above [Professional Misconduct of PWC and Ernst & Young & SLIC Supreme Court Judgment]. we hereby act knowledge your letter and the contents therein have been noted.
>
> Please note that the Council has complied with due process with regard to disciplinary procedures.[xvi]

But there were no disciplinary procedures. The author of the July 29 e-mail replied to the ICASL, pointing out that the Institute had failed to conclude its investigation of PWC and Ernst & Young, despite the fact that nearly three years had elapsed since the 10-member Ethics Committee had endorsed the findings of the investigating panel. In the meantime, the Supreme Court had reversed privatization of SLIC and had ordered the removal "forthwith" of the auditors Ernst & Young. The writer also pointed out that the Institute would soon have a new president, one Sujeewa Mudalige, Partner, PWC. Mudalige was also a member of the Sri Lanka team that worked with PWC Indonesia to carry out the privatization of SLIC.

Recommendations

Auditors are formally appointed to verify management's accounts by a company's shareholders and stakeholders. It is, therefore, their primary obligation to report to the parties who appointed them. In practice, however, this rarely occurs, as the staff of the auditing firm is in regular and frequent contact with management. As a result, the financial world has witnessed the periodic eruption of costly scandals involving improprieties by auditing firms: BCCI (PWC and E&Y) in 1992, Enron (Arthur Anderson) in 2001, Global Crossing (Arthur Anderson) in 2002, SLIC (PWC and E&Y) in 2003, Worldcom (Arthur Anderson) in 2005, and Satyam (PWC) in 2009. As a corrective measure, revisions of procedures and existing law should require auditors to interact more directly with shareholders. In Sri Lanka, the "Companies Act" was changed recently to give broader powers to auditors. If an auditor is terminated for refusing to carry out an illegal act, he or she can provide a report to the shareholders of the company being audited at the company's expense. This single provision gives auditors the independence necessary to conduct themselves with integrity, and to disclose internal misconduct and fraud.

Professional associations should also adopt a policy stipulating that any complaint made to them against an auditor should be handled with independence, transparency and dispatch. If validated, the substance of the complaint should be transmitted expeditiously to shareholders of firms audited by the subject of the complaint.

In many ways, however, safeguards are already in place. In certain cases, where interests converge, the forces of fraud, corruption and collusion are powerful enough to disarm law enforcement.[7] When not even the accountants are accountable, the public interest is largely undefended.

ENDNOTES

[i] Public Enterprise Reform Commission Report, October 25, 2006, to the Parliamentary Committee on Public Enterprise Reform.
[ii] Cabinet Memorandum, February 28, 2002.
[iii] Cabinet approval, rendered on April 4, 2002 and communicated on April 18, 2002.
[iv] Minutes of the Steering Committee meetings, March 22, 2002 and April 11, 2002.
[v] Contract between the Ministry of the Treasury and PriceWaterhouseCoopers (Indonesia) for "Investment Banking, Legal Advisory and Actuarial Valuation Services."
[vi] Ibid., Appendix C.
[vii] Appendix to Motion filed on December 13, 2007.
[viii] *The Economist,* July 7, 2002; *The Wall Street Journal,* (Asian Edition), July 8, 2002.
[ix] Public Finance Circular No. FIN 358(4), November 29, 1999.
[x] Article 52, UN Convention Against Corruption, Chapter V, "Asset Recovery."
[xi] Decision of the Ethics Committee, ICASL, July 6, 2007.

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[7] The private sector in Sri Lanka is already rumored to be investigating the possible means of revisiting the decisions of the former Chief Justice in Sri Lanka, Sarath Silva, who reversed the privatization of SLIC and the Lanka Marine Services in 2008 and 2009 ("Disputed Justice, *Lanka Business Online*, September 18, 2009)

[xii] ICASL, Act No. 23, 1959. Section 17.
[xiii] Supreme Court Judgment, SC (FR) Application No. 158/2007; Correspondence between Abdeen Associates and Ms. Yuruna Kuruppu, September 16, 2009.
[xiv] Report of the Committee on Public Enterprises to the Parliament of Sri Lanka, January, 2007, available on the website of the Sri Lanka Parliament, http://parliament.lk/.
[xv] Correspondence between Aberdeen Associates on behalf of Vasudeva Nanayakkara and the President of the Institute of Chartered Accountants of Sri Lanka. June 15, 2009.
[xvi] Correspondence between Amrit Muttukumaru and the Institute of Chartered Accountants of Sri Lanka, September 9, 2009.