

**IN THE SUPREME COURT
OF THE DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA**

*In the matter of an Application in terms of Article 121,
read with the other applicable and relevant Articles of
the Constitution, for a determination, as to whether any
one or more provisions of the Bill titled:
“Appropriation Bill 2008” is / are inconsistent with
and / or ultra-vires the Constitution.*

Nihal Sri Ameresekere
167/4, Vipulasena Mawatha
Colombo 10.

PETITIONER

SC/SD No. 3/2008

Vs.

Hon. Attorney General
Attorney General's Department,
Colombo 12.

RESPONDENT

**TO: HIS LORDSHIP THE CHIEF JUSTICE AND THEIR LORDSHIPS & LADYSHIPS THE OTHER HONOURABLE
JUDGES OF THE SUPREME COURT OF THE DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA**

WHEREAS Your Lordships' Court was pleased to Hear this Application on Friday, 24.10.2008.

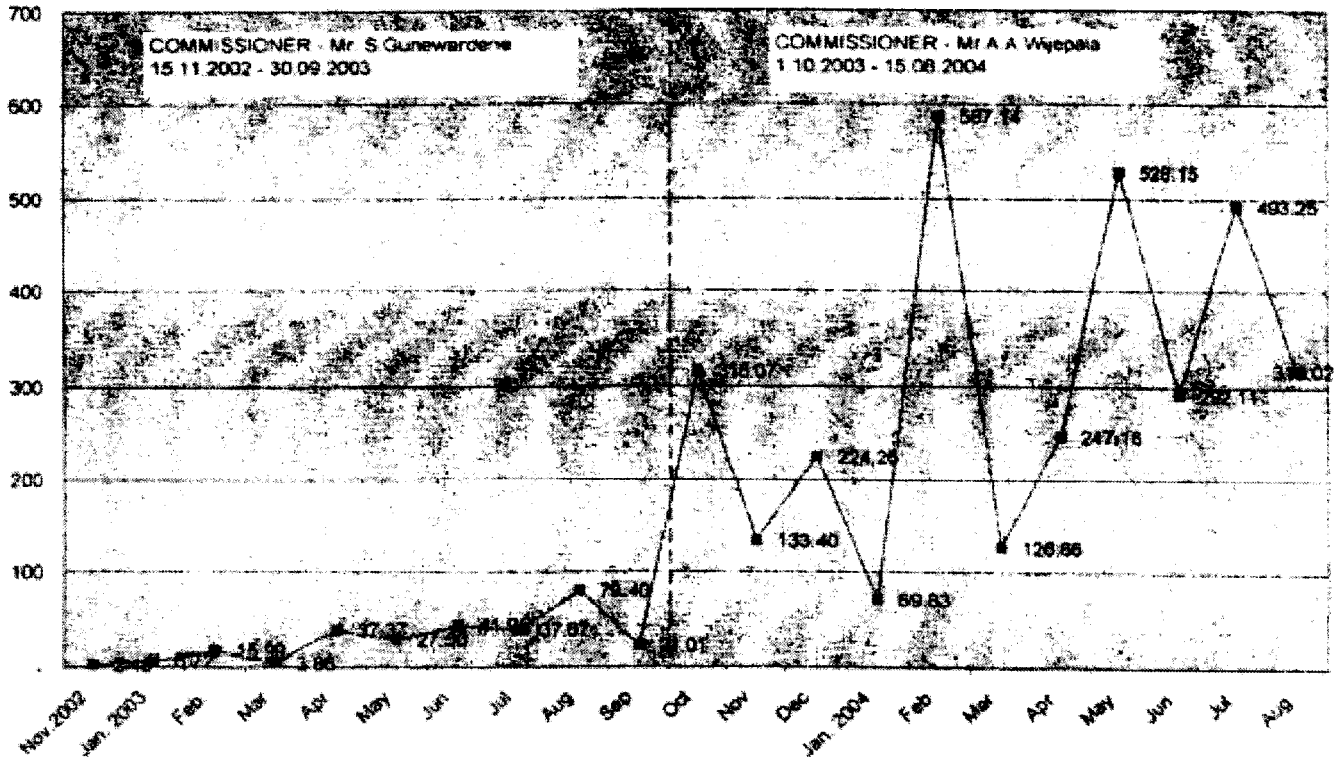
AND WHEREAS in my Oral Submissions, I inadvertently missed to draw attention of Your Lordships' Court to the following relevant matters, which I believe are pertinent, and therefore I respectfully seek the permission of Your Lordships' Court to submit same by way of this Motion.

1. I respectfully draw the kind attention of Your Lordships' Court to the 2nd Attachment to Document **P13(f)** annexed to my Petition, which is a Letter addressed to the Presidential VAT Commission, assisted by the Attorney General's Department. The said 2nd Attachment is the 'Executive Summary' of the Report of the Public Accounts Committee on the VAT fraud. A copy is annexed marked "**X**" for easy reference, with the pertinent page 3 thereof marked "**X1**", which contains a graph depicting the **steep increase** in what is reported as *fraudulent* VAT refunds.

According to my understanding, all VAT collections being credited to State Revenue, VAT refunds are made by the Department of Inland Revenue, from regular allocations of **funds obtained from the Treasury**. The graph depicts the **steep increase**, which the Treasury ought to have realised in regularly releasing allocations of funds for VAT refunds. Nevertheless, notwithstanding such **steep increase**, funds had apparently been released by the Treasury, *without any question*, as revealed by the graph cited below, **disclosing the lack of control and/or supervision over release of funds by the Treasury vis-à-vis the VAT fraud.**

Fraudulent Refunds During The periods of Two Commissioners

Rs. million



The foregoing was annexed to my Petition to demonstrate the need to enforce the 'constitutional mandate' of *Article 151 of the Constitution*, **for the Hon. Minister of Finance to specifically approve payments, with the consent of His Excellency the President, of 'unforeseen expenditure'**, for which there are no *specified budgetary provisions* approved by Parliament, for 'specified public services' and/or 'specific purposes'.

2. I also annex marked "Y", a 'Summary' of the First Schedule in the Appropriation Bill. A reporting of the **actual expenditure**, compared with these Parliamentary approved budgetary provisions, *would reveal the extent to which such budgetary provisions had been expended*, with reasons for any variations, as mandated by Sections 12 and 15 of the Fiscal Management (Responsibility) Act No. 3 of 2003. *It would also reveal any under-expenditure, which would come under the purview of Clause 5(1) of the Appropriation Bill.*

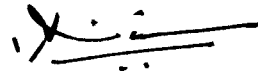
Inasmuch as the Second Schedule in the Appropriation Bill sets out in detail expenditure of approximately 1% of the Government Expenditure + Debt Service, I respectfully submit that a similar Schedule could be given in relation to 'Other Public Funds' referred to at Clauses 2, 4 and 7 of the Appropriation Bill.

Likewise, also a Schedule of the Debt Service, with Clause 2 of the Appropriation Bill disclosing the totals of Expenditure, Debt Service, Revenue and Borrowings, I respectfully submit, could be given, inasmuch as Sections 12 and 15 of the Fiscal Management (Responsibility) Act No. 3 of 2003, mandates such disclosure for public scrutiny and evaluation – i.e. **actuals compared with those budgeted**, in respect of Expenditure, Revenue, Cash Flow and Borrowings.

It is respectfully submitted that the foregoing inadvertent lapse on my part occurred, due to the time taken in dealing with Clause 2 of the Bill, whereat it was disclosed, as I recollect, that Rs. 775 billion of Debt Service had to be met next year, in addition to the stipulated Expenditure of Rs. 980 billion, *without prejudice to other law authorising any Expenditure i.e. Articles 149(2), 108(1), 65(2), 153(2), 56(6) of the Constitution*. Clause 2 of the Appropriation Bill stipulates that such Expenditure '**shall be met**' (a) from the Consolidated Fund or any other Fund (b) **from Loans authorised to be raised**; wherefore, *I most respectfully submit that, any Loans authorised to be raised could therefore be only utilised for such authorised Expenditure*; whilst Loans being re-paid are chargeable to the Consolidated Fund under the relevant Statutes.

A copy of this Motion, with the Annexures, has been hand-delivered to the Addl. Solicitor General.

On this 28th day of October 2008



Petitioner



Executive Summary

Background

The key responsibility of the Public Accounts Committee is to examine institutions in the public sector – other than public enterprises – and to report its findings to parliament with necessary recommendations.

Accordingly, your Committee conducted all its deliberations by relying upon the submissions made by Chief Accounting Officers (CAO) and Accounting Officers (AO) at the respective sessions held.

Your Committee observed at the outset of the examinations of the Department of Inland Revenue that the CAO/AO had made their declarations to the effect that they were totally in disagreement with the contents of the relevant Audit Paragraphs. As per those declarations, they did not agree with the deficiencies revealed. They maintained that there was no necessity to take any action as there were no deficiencies. However, subsequently in the process of the examination proceedings they failed to maintain that position.

Your Committee noted that there was a concerted effort to dispute and reject almost every audit finding by distorting the actual situation through misleading declarations.

Major Findings

(II) VAT fraud (given in Chapter 6 of this Report.)

- Your Committee is in agreement with the findings of the Auditor General that the IRD had fraudulently refunded VAT to the tune of Rs. 3.6 billion during the period 15.11.2002 to 15.08.2004.
- Subsequent to the above report, the Auditor General notified your committee of a further fraudulent VAT refund of Rs. 315 million made during the period 19.03.2004 to 11.08.2004 thus increasing the above identified VAT fraud to Rs. 3.9 billion. Your committee is of the opinion that this appears to be merely the tip of the iceberg, and further investigation will be required to ascertain the full extent of the defrauded amounts.
- The actual total fraudulent VAT refunds in the years 2002 to 2004 is likely to be much higher than what is presently discovered.
- Your Committee noted that lack of supervision as well as possible collusion among certain officers at the various hierarchical levels of the IRD had resulted in these fraudulent activities.
- Your Committee found that the incumbent CGIR had been the Senior Deputy Commissioner in the VAT Branch from the inception of the VAT system up to 30.06.2003 and had been the Commissioner-in-Charge of the VAT Branch from 01.10.2003 to 03.01.2005

- If fraudulent refunds of this magnitude, both in absolute and relative terms were made without his knowledge while he was performing the supervisory role of the VAT Branch, as its Deputy Commissioner and as the Commissioner of the Branch, then the incumbent CGIR's supervisory ability is highly doubtful in the very least.
- Refunds amounting to Rs. 3.648 billion out of the total fraudulent VAT refunds of Rs. 3.922 billion identified thus far had been made during the incumbent CGIR's tenure as Commissioner VAT during the period 01.10.2003 to 03.10.2005.

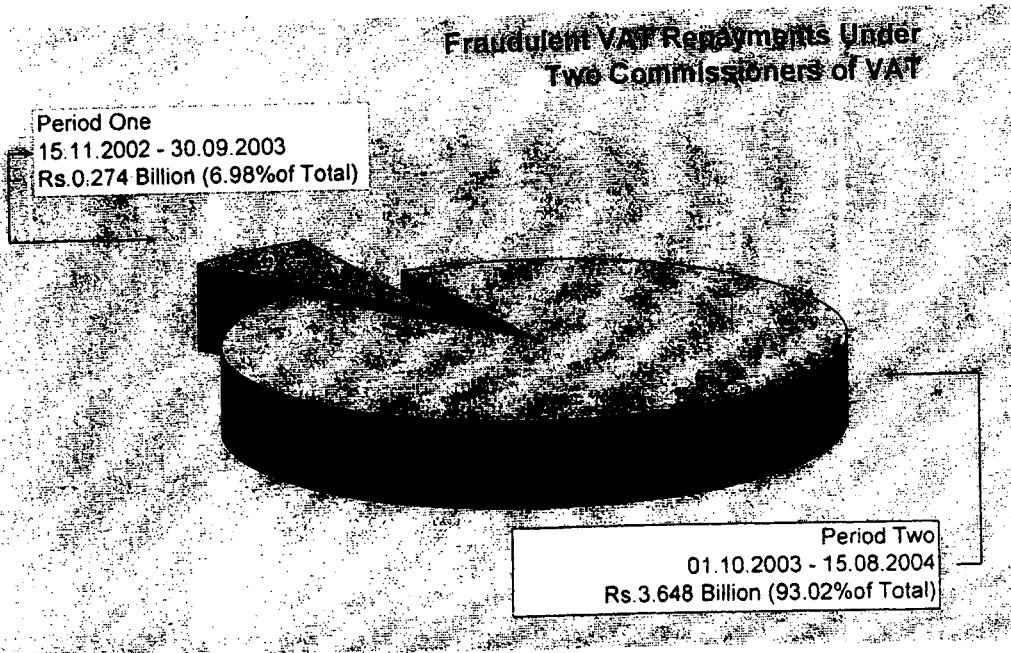


Figure 1

- Your Committee discovered that subsequent to the original audit query dated 26.03.04 on fraudulent VAT refunds, the then Commissioner-in-Charge of VAT (present CGIR), issued a circular dated 30.03 2004. This circular, issued without the knowledge and approval of the CGIR, restricted audit and investigative reports on "Refunds on Exports" to one VAT Audit Unit as opposed to the then practice of 4 VAT Audit Units being engaged in this function. By such restriction, the Commissioner-in-Charge of VAT paved the way for subsequent undetected fraud. Ironically, the head of the said Audit Unit and the senior assessor were subsequently accused of making fraudulent VAT refunds.

- There seems to be a strong correlation between the advent of the tenure of Mr.A A Wijepala to the position of Commissioner VAT and the increase in payment of Fraudulent VAT refunds.

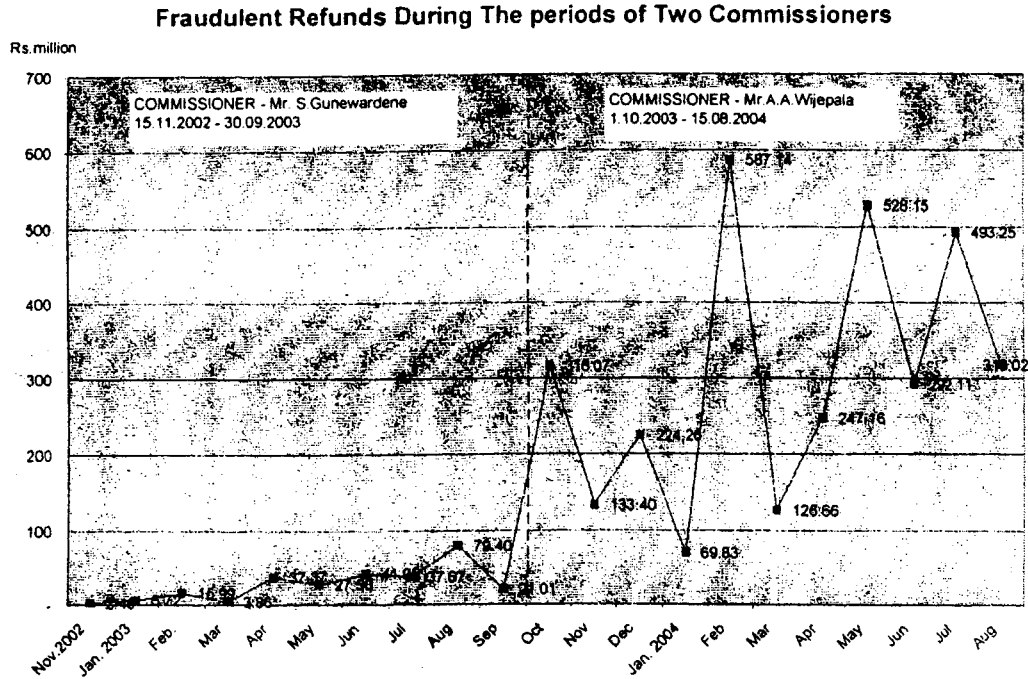


Figure 2

- As per the details submitted by the AO to CAO on 16 January 2006 your Committee was shocked to learn that documents relevant to 183 out of the 235 refunds made could not be traced. Even though this fact had been reported to the Ministry of Finance in January 2006, neither the Auditor General nor the Police had been notified. Furthermore no internal investigations had been initiated so far to identify persons responsible.
- Subsequent to the fraud being exposed by the Auditor General through an Audit query addressed to CAO and AO on 03rd June 2005, your Committee identified an inordinate delay in taking action upon the matters reported.
- According to the evidence made available to your Committee, the CAO has requested some clarifications from the AO for the first time on certain aspects of the Audit query by a letter dated 16th October 2005. Even though there were some previous correspondence relating to certain matters pertaining to the Audit query, the more significant and major issues had not been addressed.
- Most importantly, your Committee takes serious note that a Departmental inquiry had not been initiated, pertaining to the issues raised by the Auditor General. When this was questioned, the CAO/AO informed your

Committee that this was not done on the advice of the Attorney General which your Committee later found to be incorrect.

- Your Committee also observed that the Financial Regulations & Establishments Code requirements had been disregarded in not holding an internal inquiry despite the magnitude of the fraud.

(II) GST Fraud

- **Your Committee further found that similar fraudulent refunds had been made under the GST system which was in operation from 1998 to July 2002 details of which are given in Chapter 7.**
- Your Committee noted that a sample check by the Auditor General has revealed fraudulent refunds amounting to Rs. 114.6 million had been made under the GST system.
- It appeared that the VAT fraud had occurred as an extension of the above fraudulent GST refunds following a similar pattern.
- Your Committee observed that a departmental inquiry had not been carried out on the fraudulent GST refunds as per requirements of Financial Regulations and the Establishments Code.

(III) Your Committee observed that the IRD's computer system had been manipulated to the extent that two VAT Assessments amounting to Rs. 200.6 billion issued by the Department could not be viewed through the computer screen for control and audit purposes.

The details of fraudulent assessments of Rs. 200.6 billion are given in Chapter 3 of this report.

- It was found that the original declaration made by the CAO/AO was a complete rejection of the audit observation made in regard to the above. This was furthermore interpreted to your Committee by CAO/AO as an innocent mistake made by the tax payers when placing decimal places in their declarations. The Annual Report 2006 of the MOFP states that the figures referred to by the Auditor General was a misinterpretation of numerical values. Upon intense cross examination by your committee, however the CAO/AO subsequently reversed their stance to accept the audit observations
- Your Committee moreover found that the IRD had entertained two bogus VAT declarations made by two non existent firms at end of September 2004 even though the department's own investigations carried out on 16th August 2004 established the fact that these two entities were non-existent. The individual taxable supplies declared in the two documents amounted to

Rs. 1,216 billion and Rs. 108.4 billion totaling to Rs. 1,324.4 billion which constituted 73.5% of the GDP of that year.

- Your Committee noted that those two firms were the recipients of the highest amount of fraudulent VAT refunds out of the twenty firms identified in the Rs. 3.6 billion VAT fraud.
- In this regard your Committee observed that the two fraudulent declarations were arranged with the intention of confusing the VAT files relating to the said two firms and your Committee of the view that the responsibility lies with the supervisory staff of the IRD.
- These fraudulent entries were not corrected by the IRD up to 26.10.2006 that is 24 months after the entries were made and 5 ½ months after it was exposed by the Auditor General.
- Your Committee was surprised to note that CAO/AO had not taken prompt action despite the amount involved in absolute and the relative value being unrealistic and excessive.

(IV) Another significant observation your Committee made was the heavy accumulation of the tax in arrears during the last few years, details of which are given in Chapter 2 of this report.

- As per the evidence made available to your Committee, tax in arrears as at the end of the year 2000 was Rs. 22.4 billion which increased to Rs. 67.3 billion as at the end of 2003 and subsequently to Rs. 157.6 billion at the end of 2006.
- The tax in arrears as a percentage of collections during the year 2000 was 19% which had increased to 62% in the year 2006.
- When reviewing the position for the year 2006 your Committee found the annual tax collection had increased by Rs. 55 billion over the previous year while the tax in arrears had also increased by a similar amount during the same year.
- According to the published statements of the IRD and MOFP your Committee noted with great concern that a larger portion of taxes in arrears is bad and doubtful.
- As per the Performance Report – 2006 of the IRD, Rs. 125.6 billion out of Rs. 157.7 billion of taxes in arrears has become bad and doubtful.
- As per the Annual report 2006 of Ministry of Finance and Planning the possibility of recovery has further deteriorated as at 31.03.2007. Within the 1st Quarter of 2007 the taxes in arrears has increased by Rs. 10.2 billion and the estimated collectable taxes in arrears had decreased by Rs. 5.4 billion

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resulting in an overall adverse effect of Rs. 15.6 billion during the quarter referred to.

(V) When your Committee examined the position of VAT in Arrears, it was found that the position had worsened.

- By its very nature, there is no reason to have heavy accumulation of VAT in arrears, as VAT is collected by third parties on behalf of the Government and remitted to the IRD within 20 days after the closure of the VAT period.
- Surprisingly VAT in arrears had increased drastically and amounts to Rs. 74.4 billion as at the end of the year 2006. As at 31.03.2007 VAT in arrears is 51.6% of the total taxes in arrears and stands at Rs. 86.6 billion out of Rs. 167.7 billion.
- As per the report of IRD the VAT in arrears as at 31.12.2006 was Rs. 74.4 billion of which Rs. 60.0 billion is perceived as being bad and doubtful leaving only Rs. 14.4 billion as being collectible.
- Your Committee found that within the 1st Quarter of 2007 VAT in arrears had increased by another Rs. 12.2 billion to Rs. 86.6 billion.

(VI) Heavy arrears on VAT assessment notices exceeding Rs. 10 million each (Ref. Chapter 5)

- Your committee has discovered that the outstanding amounts of individual VAT dues exceeding Rs.10m has remained uncollected for periods ranging from two to four years.
- Your committee noted however that of the total outstanding balance in this category of Rs.271.254 billion, it was subsequently reported that Rs. 200.6 billion were fraudulent assessments.
- Even after the fraudulent assessments were excluded, the outstanding balances remained very high as at 15.05.2006 representing 82.7% of the revised figure of Rs. 48.89 billion and the amount collected was only Rs. 8.48 billion representing 17.3%.
- As these assessments were issued only to 233 institutions, your Committee is of the view that the IRD should have been paid special attention to the fact of the limited number of institutions involved, considering the high values of these assessments.
- When the CAO/AO were examined by your Committee they failed to show any progress over the recovery and provide any updated information on this matter.

(VII) Systems and Control Weaknesses

- Your Committee observed much non-compliance with statutory/regulatory requirements.
- The delegation of financial authority stipulated in FR 135 amplified in FRR 136/137/138 and 139 were ignored by the IRD.
- That situation has enabled avoidance of all the possible internal checks to be performed in the operation of the systems and to commit all these irregular transactions. Even though Financial Regulations and Establishments Code required action to be taken on delays, negligence, fault or fraud of an officer in non-compliance with requirements, your Committee noted those requirements were not adhered to.
- Even after the fraudulent transactions were observed, no internal inquiry has been conducted to identify the causes of losses and officers responsible.
- Deliberate delays in initiating inquiries on audit queries raised on 26th March 2004 allowed Mr. Z. Jayatilleke, Deputy Commissioner in Charge of VAT refund, who is presently in remand custody, to retire on 27.01.2005 with full pension rights without any inquiry. The other officer, Mr. Ambepitiya, who is in remand custody and is presently being prosecuted, continues to be paid his full salary without any internal inquiry.

Under the Establishments Code discretionary power is vested with the Head of the Institutions to recommend to the Disciplinary Authority to interdict the person as the offences identified warrant an interdiction or alternatively sending the said party on compulsory leave on full-pay.

- Your Committee paid its attention to the safety of the documents related to the fraudulent transactions and found 183 out of 235 payment documents relevant to VAT fraud of Rs. 3.6 billion to be missing.

This situation had not been reported to the Police and no investigation has been initiated to discover those responsible for the loss of these documents.

- The possibility of having more documents missing or subject to be manipulated cannot be ruled out.
- Your Committee found the Internal Control Systems to ensure prevention and detection of frauds and errors, the maintenance of the accuracy and completion of Accounting Records for timely preparation and presentation of reliable financial information to be very poor.
- The secrecy clause as stipulated in the Inland Revenue Act has been used as a shield to cover up misdeeds committed and to avoid internal investigations and inquiries.

- The situation has been further aggravated in certain situations when some senior officers continued to serve in the same post for prolonged periods within the same branch or unit even after obtaining promotions.
- Wide ranging discretionary power is vested in the CGIR to confer power to waive or to write off any penalty imposed by the Department. Your committee is of the opinion that sufficient checks and balances have not been inbuilt in the system to maintain a significant level of transparency and audit trail.
- Your Committee further noticed the system was further weakened by restricting the submission of information to Auditor General to assist your Committee and the Parliament. This seems to be a limitation of rights vested with the Auditor General in terms of Article 154 (5) of the Constitution.

Recommendations

In addition to the individual recommendations given in the each of following Chapters, your Committee submits following recommendations;

- * Your Committee recommends an investigation to be carried by a team of IRD officials under the purview of your Committee.
- * The boundaries of that investigation should expand beyond the reported VAT fraud and cover the possible irregularities of tax collections and fraudulent tax refunds not yet detected.
- * To facilitate the conduct of an unimpeded and independent investigation as proposed by your committee it is imperative that the present Commissioner General of IRD should be relieved of his duties until the investigations are over as the role he has played, directly and indirectly in this mater is open to question.
- * The proposed investigation by your committee is of paramount importance in exercising parliamentary oversight of public finance. The Presidential Commission already appointed may conduct its inquiry independent of the investigations proposed by your Committee.
- * It is necessary to emphasize the importance of introducing and implementing a sound Internal Control System, and Management and Accounting Information System to address most of the system weaknesses prevailing in the Department, with a sound database.
- * Take prompt action to have a clean tax assessment system based on objectivity to ensure the timeliness of revenue collection.
- * Sound Planning System to make Medium Term Plans to provide a firm basis for revenue forecasting for Annual Budget Exercise and to prepare a realistic Action

Plan with monthly targets on each tax component to make the reviews at executive level and Parliamentary level.

- ★ Introduce proper procedures based on the manuals to ensure the highest possible compliance with statutory and other regulatory requirements.
- ★ Enforcement of the Code of Ethics already introduced to avoid the recurrence of the unacceptable situations experienced in the form of fraudulent tax refunds not only at the cost of the general public but also the loss of public confidence in the Department.
- ★ Effective supervision at all the levels of the staff to ensure smooth flow of Departmental Activities on Tax Administration and Revenue Management.
- ★ Finally your committee proposes the enactment of a public interest disclosure act to enable and encourage public sector employees to expose corruption and malpractices in the public sector with a guarantee of absolute confidentiality and protection from any possible victimization. In this regard the Ministry of Finance must initiate action to examine examples of "whistleblower" protection legislation in other countries and adopt the necessary measures.

Estimates of 2009

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	2009	
	Recurrent (Rs.)	Capital (Rs.)
Head 1 - 22	6,487,958,000	4,670,059,000
Ministry of Religious Affairs and Moral Upliftment	646,847,000	462,655,000
Ministry of Finance and Planning	19,160,455,000	49,211,895,000
Ministry of Defence, Public Security, Law and Order	158,370,989,000	18,689,050,000
Ministry of Plan Implementation	163,695,000	31,175,000
Ministry of Nation Building and Estate Infrastructure Development	19,657,076,000	36,075,562,000
Ministry of Disaster Management & Human Rights	362,725,000	1,637,760,000
Ministry of Tourism	101,929,000	1,708,622,000
Ministry of Posts and Telecommunications	6,822,635,000	242,042,000
Ministry of Justice and Law Reforms	6,247,090,000	1,929,135,000
Ministry of Healthcare and Nutrition	43,990,864,000	14,659,030,000
Ministry of Foreign Affairs	4,815,863,000	806,255,000
Ministry of Ports & Aviation	255,991,000	36,256,209,000
Ministry of Transport	14,301,852,000	14,760,350,000
Ministry of Petroleum and Petroleum Resources Development	136,080,000	305,610,000
Ministry of Trade, Marketing Development, Co-operatives and Consumer Services	709,485,000	770,253,000
Ministry of Highways and Road Development	123,883,000	77,004,625,000
Ministry of Agricultural Development and Agrarian Services	32,081,817,000	11,034,885,000
Ministry of Power and Energy	1,635,930,000	36,405,375,000
Ministry of Child Development and Women's Empowerment	986,808,000	240,210,000
Ministry of Public Administration and Home Affairs	86,385,000,000	2,500,000,000
Ministry of Mass Media and Information	1,400,305,000	492,850,000
Ministry of Urban Development and Sacred Area Development	286,563,000	10,010,048,000
Ministry of Social Services and Social Welfare	669,208,000	204,150,000
Ministry of Housing and Common Amenities	108,406,000	889,375,000
Ministry of Education	22,639,414,000	4,619,850,000
Ministry of Labor Relations and Manpower	1,105,554,000	431,700,000
Ministry of Rural Industries and Self Employment Promotion	448,330,000	171,450,000
Ministry of Vocational and Technical Training	2,412,712,000	2,227,675,000
Ministry of Local Government and Provincial Councils	78,182,310,000	32,354,920,000
Ministry of Enterprise Development and Investment Promotion	203,835,000	1,569,910,000
Ministry of Science and Technology	1,079,768,000	2,010,160,000
Ministry of Constitutional Affairs and National Integration	229,385,000	118,525,000
Ministry of Plantation Industries	1,708,883,000	3,296,250,000
Ministry of Sports and Public Recreation	790,544,000	886,950,000
Ministry of Indigenous Medicine	797,544,000	1,002,095,000
Ministry of Fisheries and Aquatic Resources	970,650,000	6,684,968,000
Ministry of Livestock Development	401,830,000	959,965,000
Ministry of Cultural Affairs and National Heritage	1,255,384,000	1,797,100,000
Ministry of Parliamentary Affairs	292,975,000	34,550,000
Ministry of Re-settlement and Disaster Relief Services	2,404,881,000	2,045,225,000
Ministry of Industrial Development	345,371,000	926,825,000
Ministry of Foreign Employment Promotion and Welfare	77,919,000	432,725,000
Ministry of Irrigation and Water Management	1,339,925,000	10,813,475,000
Ministry of Land and Land Development	1,944,744,000	1,928,950,000
Ministry of Youth Affairs	633,643,000	1,122,075,000
Ministry of Environment and Natural Resources	1,604,440,000	2,885,450,000
Ministry of Internal Administration	708,810,000	1,301,300,000
Ministry of Youth Empowerment and Socio Economic Development	69,545,000	515,450,000
Ministry of Community Development and Social Inequity Eradication	58,710,000	300,400,000
Ministry of Water Supply and Drainage	149,470,000	28,564,000,000
Ministry of Export Development and International Trade	454,981,000	473,725,000
Ministry of Public Estate Management and Development	79,781,000	10,800,000
Ministry of Construction and Engineering Services	339,602,000	107,908,000
Ministry of Higher Education	11,634,460,000	9,483,050,000
Ministry of Supplementary Plantation Crops Development	169,925,000	115,075,000
TOTAL	540,444,779,000	440,189,681,000

Rs. 980,634,460,000