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# ENHANCING FINANCIAL DISCLOSURE STANDARDS in Transitional Economies II

Asian Development Bank

# Enhancing Financial Disclosure Standards in Transitional Economies II

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Asian Development Bank

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# Foreword

The Asian Development Bank (ADB) is committed to good corporate and financial governance and promoting efficient public and private sector development in its developing member countries. Rational public and private investment decisions require accurate and timely disclosure of information. This requires that businesses adhere to transparent financial disclosure in line with International Financial Reporting Standards (IFRS) in the case of financial statements, and International Standards on Auditing (ISA) for their audits.

Adoption of these standards is challenging, especially in transition economies. This book summarizes the work undertaken by ADB in several Central and West Asian member countries. I believe this is a good guide to what is needed on the disclosure front. The book targets practitioners and policy makers.

I thank Radhakrishna Narasimham, principal financial management specialist in ADB, for managing the research and writing the book.

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# Preface

The Asian Development Bank (ADB) is committed to strengthening corporate and financial governance and promoting efficient public and private sector development in its developing member countries. Rational public and private investment decisions need accurate and timely disclosure of information relating to the financial condition of investor and investee institutions. This requires their adherence to transparent financial disclosure in line with International Financial Reporting Standards (IFRS) for the preparation of financial statements, and International Standards on Auditing (ISA) for their audit. This is particularly so since IFRS and ISA have emerged as a uniform global standard.

The implementation of IFRS and enforcement of ISA in transitional economies poses a particular challenge given the nascent stage of development of their legal, regulatory, and jurisprudence systems and the different purposes that the accounting and auditing functions served during the era of central planning. At that time, state agencies were the only users of accounting information. The prime function of accounting was to monitor and control the use of economic resources against planned targets. Accounting was prescribed through detailed regulation based on form. It was not based on substance governed by a set of principles. Auditing in a centrally planned economy was limited to an inspection function where compliance with regulations took precedence over truth and fairness. The transitional economies' erstwhile accounting and auditing systems therefore proved inadequate to the needs of a market economy. Inevitably, this dichotomy created regulatory gray areas that allowed financial irregularities, improprieties, and illegalities to occur in the countries' enterprise and financial sectors.

Armenia, Azerbaijan, and Georgia recognize the importance of good financial governance standards for improving the investment climate and requested ADB's assistance in this endeavor. ADB and the three countries concurred that enhancing their accounting standards in line with IFRS and strengthening their auditing standards in accordance with ISA would be necessary to achieve improved standards of financial disclosure and governance.

ADB approved in 2005 a regional policy and advisory technical assistance (TA) grant (TA 6249-REG) to help Kazakhstan, the Kyrgyz Republic, Mongolia, and Uzbekistan enhance their financial disclosure standards. Specifically, the TA project sought to improve their accounting standards in line with IFRS and to upgrade their auditing standards in accordance with ISA. The outputs of that TA project were widely appreciated by the four countries as relevant in addressing capacity issues in the implementation of IFRS and enforcement of ISA. A book on the outcome of the project, titled *Enhancing Financial Disclosure Standards in Transitional Economies,* was published in 2008.

Given the basic structural similarity of the former Soviet Union countries' legal and regulatory framework for financial disclosure and the wide appreciation in Central Asia of ADB's earlier TA project, a similar intervention also through a TA grant (TA 6505-REG), as requested by the three countries, was replicated in Armenia, Azerbaijan, and Georgia. The project design drew upon lessons learned from earlier ADB regional and country-specific TA projects. Adopting an integrated approach, the project identified and addressed weaknesses in each country's institutional, legal, and regulatory frameworks that have inhibited the adoption of IFRS and enforcement of ISA. Three country-specific workshops and a regional seminar encouraged productive interface and debate on common problems, exploiting synergies and enabling the countries to share their experiences in a cost-effective manner.

As a result, each country was able to develop an action plan for strengthening its financial disclosure standards. The three governments deeply appreciated the project's findings, outputs, and recommendations, and believed that publishing the information would contribute valuable knowledge of financial disclosure in their countries. ADB concurred with the governments' thinking.

This book draws together the project's outcomes. It is a useful reference on financial disclosure in the three countries, and may trigger further diagnostic and research activities in other transitional economies.

Given the general similarity in the two groups of countries' legal and constitutional histories, a section in this publication explains the differences noticed in their financial governance. This TA project covered a theme similar to and in continuation of ADB's previous TA project in Central Asia but for different countries. The publication is hence eponymously titled *Enhancing Financial Disclosure Standards in Transitional Economies II* to distinguish it from the previous volume.

I would like to acknowledge and thank several individuals without whose support this book could not have been written. George Brittain, the team leader from Corporate Solutions, the consultants, provided substantial support in conducting the three country-level seminars and the regional seminar, and contributed to the contents of the three countries' chapters and the appendixes of this publication. Valuable support was provided by Maritess Marcelino, assistant project analyst, in implementing the TA project, and Marishka Etrata, administrative assistant, in conducting the regional seminar and in publishing this book. Special thanks are due to Magi Nagizyan, Elshan Rahimov, and Temuri Partskhaladze, the national consultants for Armenia, Azerbaijan, and Georgia, respectively, who helped conduct the country-specific seminars and whose outputs went into the country action plans. The contributions of the resource speakers—Otar Gorgdoze, Andrei Busuioc, Michael Wells, Jon Hooper, Natalya Vovchuk, and Lynn Lynch—are also highly appreciated.

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# Abbreviations

| | | |
|---|---|---|
| AAAA | – | Association of Accountants and Auditors of Armenia |
| ACAA | – | Association of Certified Accountants of Azerbaijan |
| ACCA | – | Association of Certified Chartered Accountants |
| ADB | – | Asian Development Bank |
| ASRA | – | Accounting Standards of the Republic of Armenia |
| AZCOA | – | Azerbaijan Chamber of Auditors |
| AZLAS | – | Azerbaijan Law on Auditing Services |
| AZLOA | – | Azerbaijan Law on Accounting |
| EU8D | – | European Union's 8th Directive on Company Law |
| FASB | – | Financial Accounting Standards Board |
| FRC | – | Financial Reporting Council |
| GDP | – | gross domestic product |
| GFPAA | – | Georgian Federation of Professional Accountants and Auditors |
| GLOA | – | Georgia Law on Auditing |
| GLRAR | – | Georgia Law on Regulation of Accounting and Reporting |
| IAASB | – | International Auditing and Assurance Standards Board |
| IAS | – | International Accounting Standards |
| IASB | – | International Accounting Standards Board |
| IFAC | – | International Federation of Accountants |
| IFRS | – | International Financial Reporting Standards |
| IOSCO | – | International Organization of Securities Commissions |
| ISA | – | International Standards on Auditing |
| LARA | – | Law on Accounting of the Republic of Armenia |
| LOAA | – | Law on Auditing of Armenia |
| MOF | – | Ministry of Finance |
| MSME | – | micro, small, and medium-sized enterprises |
| NASCO | – | National Accounting Standards for Commercial Organizations |
| NGO | – | nongovernment organization |
| OECD | – | Organisation for Economic Co-operation and Development |
| PASC | – | Parliamentary Accounting Standards Commission |
| PIE | – | public interest enterprise |
| ROSC | – | Report on the Observance of Standards and Codes |
| SARA | – | Standards on Audit of the Republic of Armenia |
| SMEs | – | small and medium-sized enterprises |
| SRO | – | self-regulatory organization |
| TACIS | – | Technical Assistance to the Commonwealth of Independent States |
| USAID | – | United States Agency for International Development |
| USGAAP | – | United States Generally Accepted Accounting Principles |

# I. Introduction

In their transition from centrally planned to market economies, Armenia, Azerbaijan, and Georgia have opened up several economic sectors to increased domestic and foreign private investment and market borrowing. In doing so, they have recognized that potential investors and creditors want timely, reliable, and accurate information about the financial condition of enterprises being opened to private investment. Good corporate governance needs transparent and timely dissemination of corporate and financial information. This is particularly so as cross-border investment flows have increased considerably due to the (i) relaxation of (capital) exchange controls, (ii) asymmetries in countries' domestic savings and investment rates, and (iii) rapid improvements in the speed of funds transfer across national boundaries.

It is therefore imperative to have an internationally recognized benchmark for financial disclosure and reporting. Such a benchmark will reduce the inherent risk in financial intermediation (through information arbitrage) and interpretation, and would thereby lower its cost. It is also necessary for these countries' accounting and auditing systems to be integrated with internationally recognized standards to provide reliable financial information to potential investors and creditors. High-quality financial statements are crucial for informed decision making and for the efficient and rational allocation of resources.

The International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB)[1] are internationally recognized principles of financial disclosure mandated for public companies in over 70 countries. International Standards on Auditing (ISA) are the set of auditing standards established by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC). IFRS and ISA are internationally recognized benchmarks for financial disclosure and auditing. This is particularly so given the convergence and ultimate harmonization of IFRS with the United States Generally Accepted Accounting Principles. Chapter II defines IFRS and ISA, their rationale, and the challenges to their adoption in transitional economies. ADB recognizes the necessity for its developing member countries to enhance the quality and transparency of their financial disclosure and reporting by adhering to IFRS and ISA for strengthening their corporate and financial governance practices. ADB also recognizes the importance of capacity building in its developing member countries for the application of IFRS and the enforcement of ISA.

TA 6505-REG: *Enhancing Financial Disclosure Standards in Armenia, Azerbaijan, and Georgia* was ADB's first intervention in this sector in the South Caucasus region. ADB processed and implemented this TA project in the light of the knowledge and experience gained from its successful earlier project in Central Asia (TA 6249-REG), with suitable modifications given the individual countries' issues. The previous TA project identified the issues and challenges to transitional economies' adoption of IFRS and enforcement of ISA, and highlighted these in a publication.[2] The contents of that publication helped the three countries in the South Caucasus prioritize their agendas for reform of financial disclosure. Analyses of the issues and problems faced in each country were necessary for recommending appropriate measures to address the issues and solve the problems.

Between June and November 2009, following detailed and participatory consultations with stakeholders in the three countries, and in accordance with its terms of reference, the TA project (i) prepared methodologies

[1] International Accounting Standards were classified as IFRS in 2001 by the IASB.
[2] R. Narasimham and E. Adhami. 2008. *Enhancing Financial Disclosure Standards in Transitional Economies.* Manila: Asian Development Bank.

for reconciling income and asset values computed according to IFRS to domestic tax laws in the three countries (Appendix 1), (ii) prepared guidelines for domestic audit firms' audit of publicly listed companies and quality control of audits in the three countries, (iii) translated certain ISA guidelines into regional languages, (iv) trained regulators on updated IFRS and ISA, and (v) held a single regional seminar for all three countries as a culmination of all 18 country-level activities undertaken earlier.

Chapters III to V describe the country-level activities and their outcomes. Three individual country-level workshops (5 days for Georgia and Armenia and 2 days for Azerbaijan) were held between July and October 2009. They were attended by 67 participants representing a wide range of regulatory bodies: accountants, auditors, professional associations, accounting policy departments of ministries of finance, stock exchanges, tax authorities, financial supervision agencies, and universities. The workshops were designed in consultation with stakeholders in the beneficiary countries. They covered the relevance of international accounting and auditing standards, regulatory regimes, codes of ethics, and professional bodies, as well as taxation in the specific context of each country. The country workshops were designed to ensure that the regional interface sought under the project complemented, but did not supplant, the country-specific focus envisaged, given the differing levels of progress in accounting reforms made by the three countries. Specific country action plans emerged out of the country-level workshops (Appendixes 2 and 3), which were then deliberated and adopted at the regional seminar. These plans provide valuable insights into the actual problems faced and articulate the priorities of the national governments.

Following the successful conclusion of the country workshops, a regional seminar was held in Tbilisi in November 2009 to offer a forum for regulators from the three countries to share their knowledge and experience and consult with prominent international experts. Chapter VI discusses the regional seminar's outcomes and the reform process it motivated, and Appendix 3 provides its agenda and attendees' list. Some 35 delegates from various institutions responsible for the development of accounting and auditing standards in the three countries attended the seminar. A number of resource speakers from international organizations, including the IASB, the Financial Reporting Council, the United States Agency for International Development (USAID), the World Bank, and Companies House[3] participated in the seminar.

Importantly, the regional seminar identified common lessons learned from the three countries' problems and provided a forum for suggestions for ameliorating them. The regional seminar was instrumental in finalizing the three country action plans and the basis for the countries' coordination in this area after the conclusion of the TA project. In its deliberations, ADB summarized and presented to the regional seminar the similarities and differences between the issues faced by the four countries covered by ADB's earlier TA project and the three countries covered by this one. This information is presented in Chapter VI. Key issues affecting ongoing reform of financial reporting and disclosure were identified. These were (i) standards gaps, (ii) compliance gaps, (iii) lack of local language translations of IFRS and ISA, (iv) contradiction between IFRS and national tax accounting requirements, (v) poor awareness of the IFAC ethics guidelines, (vi) weak control and supervision of the accounting profession, and (vii) poor corporate governance standards. Potential solutions to these issues were proposed at the regional seminar and are highlighted in Table 7.

The majority of enterprises in transitional economies are in the category of micro, small, and medium-sized enterprises (MSMEs), although their definitions vary across jurisdictions. Most MSMEs, because of their small size and limited resources, have not been able to adopt IFRS, nor have they had their financial statements audited according to ISA. This has resulted in difficulty in accessing debt and equity finance. ADB's experience in Central Asia found that the majority of MSMEs did not follow the very standards ADB was encouraging the regulators to apply and enforce. ADB's interventions for financing the MSME sector are growing in importance, given this sector's increasing contribution to gross domestic product and

[3] Companies House functions as the registrar of companies in the United Kingdom. It is a nonprofit public service company, wholly state owned. It has a database containing all corporate information.

employment. It is therefore in the interests of ADB and the governments of its developing member countries to help MSMEs improve the quality and transparency of their financial disclosure in accordance with IFRS and ISA. In July 2009, the IASB brought out a new IFRS for small and medium-sized enterprises (SMEs). Given its recent announcement, this IFRS was discussed only briefly at the regional seminar but drew considerable interest of the three countries' regulators and resource speakers. If SMEs in these countries were to adopt this new IFRS it could improve considerably the quality of their financial disclosures. Microenterprises may find it difficult to adopt even these modified IFRS. Given their small size in terms of employment and turnover, it would be more appropriate if they were governed by even simpler disclosure requirements. Chapter VII contains a brief description of this standard and discusses possibilities for its future adoption.

Overall, the TA project has stimulated debate and facilitated knowledge transfer on enhancing financial disclosure standards in the three beneficiary countries. Adopting an integrated approach, the project has helped to highlight weaknesses in each country's institutional, legal, and regulatory frameworks that may inhibit adoption of IFRS and enforcement of ISA. This approach has promoted interface and debate on the common problems by exploiting synergies and sharing experiences across countries while adopting a cost-effective approach to such discourse. The design, contents, and implementation of this TA project were much appreciated by the governments and regulators of the participating countries. The deliberations at the regional seminar were recognized as being participatory, practical, and relevant to identifying and seeking solutions to the problems in financial disclosure. Therefore, ADB and the participants deemed it meaningful to publish highlights of the accomplishments and lessons learned from the project so that other countries dealing with similar challenges may benefit from the knowledge gained. These conclusions are highlighted in Chapter VIII. Based on the results of its earlier TA project and its associated publication, ADB hopes that the outputs and recommendations of this TA project, as highlighted in this publication, will improve the quality of corporate and financial governance in the three countries.

# II. International Financial Reporting Standards and International Standards on Auditing Definition, Rationale, and Challenges in Adoption

## International Financial Reporting Standards

International Financial Reporting Standards (IFRS) are the accounting rules issued by the International Accounting Standards Board (IASB).[4] IFRS were developed in the public interest as a single set of high-quality, transparent, comparable, and enforceable global accounting standards. They are internationally recognized principles of financial disclosure mandated for public companies in over 70 countries. The majority of IFRS—from their exposure draft stage up to their adoption as a standard—were written, debated, amended, and finalized by accountants from the English-speaking parts of the world.

IFRS is characterized by the following features: (i) it is a transaction-centered reporting system based on accounting principles and not a procedure-centered reporting system based on accounting rules (in contrast to the United States Generally Accepted Accounting Principles [USGAAP]—to be discussed later); (ii) its application demands the prevalence of substance over form; (iii) it is a double-entry accrual accounting system following certain important concepts and conventions; (iv) its concepts are the money measurement concept, the business entity concept, the going concern concept, the cost concept, the dual aspect concept, and the realization concept (matching costs to revenue concept); and (v) its conventions are those of accrual, consistency, conservatism, and materiality.[5]

The money measurement concept states that accounting records concern only those transactions that can be expressed monetarily. Money alone provides the common denominator by which various heterogeneous factors can be expressed quantitatively and numerically. A company will thus not record in its books any special advantage such as excellent managerial ability, good industrial relations, or good location if it did not pay for them specifically. Likewise, unquantifiable events, such as the loss of the chief executive in an accident or resignation, or low staff morale, find no place in the accounts.

The business entity concept recognizes the business to be a separate entity from its owners. This is particularly necessary for a joint stock company, where the management is distinct from its shareholders. Such reporting identifies profit or loss for any particular economic activity and monitors a company's

[4] IFRS replaced International Accounting Standards (IAS) in 2001, and the International Accounting Standards Committee was replaced by the IASB. Appendixes 4 and 5 provide details on changes to IFRS and ISA.

[5] R. N. Anthony and J. S. Reece. 1975. *Management Accounting Principles*. Illinois: Richard D. Irwin Inc.

management or its responsible use of shareholders' funds—an important ingredient of corporate governance. Financial statements thereby report on how well management is discharging this responsibility.

The going concern concept assumes that a business' life will continue indefinitely (important for legal entities enjoying perpetual succession). This concept is important for the valuation of a company's assets over their lifetime. It assumes that a business will remain in existence long enough to charge against its income the cost of its fixed assets over their useful lives and to amortize over an appropriate period other deferred costs. On this basis, a company's fixed assets are valued at cost less depreciation. If a business were to be liquidated within a current year, fixed assets would be valued at their realizable value.

The cost concept holds that accounting entries record transactions on an objective basis at their actual and real costs. Therefore an asset is ordinarily entered into the accounting records at the price paid for its acquisition. This cost will thereafter be the basis for the asset's subsequent accounting. This is closely related to the going concern concept for recording a company's fixed assets at their cost less depreciation. By contrast, if a company does not pay for an item it acquires, it does not have a cost for its financial records. The cost concept is an illustration of the application of the criteria of relevance, objectivity, and materiality in accounting.

The dual aspect concept mandates that every debit has an equal and corresponding credit. This is the fundamental ingredient of the double-entry accounting system. On a company's balance sheet, its owned resources are its assets. Its liabilities side comprises the claims against its assets, first from its external creditors, and then from its shareholders. The double-entry accounting system requires a company's total assets and liabilities to be equal—which is why it is "balanced" in the balance sheet.

The realization concept (also known as the matching costs to revenues concept) holds that profit is realized and accrues to an entity (when it is recorded) after deducting costs from revenues, i.e., when revenues (recognized according to the accrual concept) are matched with and offset against the costs incurred to realize them. This is closely related to the dual aspect concept mandating that every debit requires an equal and corresponding credit.

The accrual convention holds that revenues and costs are recorded only when they are earned and incurred—not necessarily when they are received or paid. The realization of an item of income or expenditure is different from its mere receipt or payment. This convention is closely related to the realization concept.

The consistency convention holds that an entity will follow the same basis for accounting for its assets, liabilities, income, and expenditure from year to year. Events of a similar nature will be recorded in a similar manner over time. Consistency of principles is a necessary yardstick for facilitating comparison of financial performance between different entities and of the same entity between different years. Auditors certifying financial statements are required by law to state categorically that a financial statement's preparation is consistent with the previous years.

The convention of conservatism mandates that an entity must be conservative in its accounting practices. It may provide for losses but should not anticipate profits that have not accrued or have not been realized. It is prudent to acknowledge uncertainties in events and circumstances that may affect values in financial statements. Prudence requires caution in making judgments. Under this principle companies value their current and liquid assets at cost or market value, whichever is lower. This is because unlike fixed assets, which are required for a company's operation over a long period, current assets have to be realized within 1 year and hence recorded at their realizable value.

The convention of materiality holds that an entity must make full and material disclosure of all matters important for providing a user of financial statements with a true and fair view of the company's financial condition. The definition of materiality is relative and dependent on individual circumstances. Transactions and other events must therefore be presented in accordance with their substance and not merely in legal form. Information provided in financial statements must therefore also be relevant to its users' decision-making needs. To be relevant, information must be reliable (free from material error and bias), complete (within the bounds of materiality and cost), and timely (within a prescribed time frame for decision making).

IFRS have been adopted and have become the mandated financial reporting standards in 70 economies including Australia; Canada; the European Union; Hong Kong, China; Malaysia; New Zealand; Singapore; and South Africa. They have also been adopted by international organizations such as the World Bank, the World Trade Organization, and the International Organization of Securities Commissions (IOSCO). The US Securities and Exchange Commission announced in April 2007 that effective 2010, it would accept financial statements prepared according to IFRS.

The IASB and the Financial Accounting Standards Board (FASB) of the United States (US) are engaged in a convergence project with each agreeing to adopt six standards from the other (where there is a mutual agreement that the other's standard is more relevant). Where neither body has a particularly strong standard, a new standard will be produced. This convergence will be completed by the end of 2011, when there will thereafter be one global standard—IFRS. The USGAAP will cease to exist. There are also convergence projects for the adoption of IFRS in the People's Republic of China and Japan.

Therefore, IFRS would be the first globally mandated financial reporting standard, and constitutes a most suitable benchmark for the harmonization of individual country and company financial result statements.

IFRS standards are generally applicable to revenue-earning legal entities (regardless of whether or not they are state owned). IFRS are inapplicable to state budgetary organizations, although these sometimes follow International Public Sector Accounting Standards which, though also developed by the IASB, are different from those of the IFRS.

## International Standards on Auditing

International Standards on Auditing (ISA) are the set of auditing standards established by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC). Between 2006 and 2009, five auditing standards were redrafted, and their objectives set out and followed by guidance requirements. An additional 13 redrafted exposure drafts have been published. These are expected to become effective by 2011.

ISA are the only globally accepted auditing standards and were designed to audit financial statements prepared according to IFRS. Hence, updates and revisions have followed in tandem with changes to IFRS. It is, however, possible to use ISA with some modifications in interpretation to audit non-IFRS statements, e.g., those prepared under USGAAP. Like IFRS, ISA were also mostly written by auditors from the English-speaking world.

Since 2005, ISA has introduced fiduciary standards for quality control. These embody five principles: (i) integrity, (ii) objectivity, (iii) professional competence and due care, (iv) confidentiality, and (v) professional ethics and behavior.

## Challenges in the Use of International Financial Reporting Standards and International Standards on Auditing

### Background

Although IFRS and ISA are globally accepted standards for financial disclosure and auditing, their global application and enforcement has faced challenges for a number of reasons.

First, the majority of IFRS and ISA (initially as exposure drafts) were written by accountants and auditors from English-speaking common law countries whose jurisprudence systems had the benefit of judicial precedent. This environment was difficult to replicate in civil law jurisdictions. The methodology for the application of IFRS and enforcement of ISA in civil law countries has now been facilitated by the European Union's 8th Directive on Company Law (EU8D) on financial disclosure.[6] The successful application and enforcement of IFRS and ISA has drawn heavily on the regulatory and reporting requirements of developed common law countries such as Australia, Canada, New Zealand, and the United Kingdom (UK). In these countries their application has been greatly helped by the presence of (i) institutional infrastructure that complements reporting requirements; (ii) well developed markets for corporate control; (iii) a large base of institutional shareholders effective in monitoring and disciplining company management; (iv) strong investor protection laws that are diligently enforced; (v) strong corporate governance systems mandating public companies to disclose all their relevant information to the registry of companies (footnote 3); (vi) facilitative legislation for stockholder and lender litigation, combined with relatively quick court processes to punish guilty company managements where warranted; and (vii) their common law jurisprudence systems that gave their courts the benefit of judicial precedent for deciding cases in areas not specifically legislated for. These countries' tax authorities also reported to their corporate regulators any suspicious activities noticed by them, which assisted the companies' corporate regulators in their compliance with their mandatory reporting requirements under their company laws.

Without these ingredients of good corporate governance, merely having legislation to comply with IFRS and ISA without enforcing it will lead to a compliance gap. While institutional features may take longer to develop, financial reporting can be improved in the short run through a system of incentives for transparent reporting and punishments for misreporting. Punitive measures for noncompliance would reduce the incentive to cheat. Company management needs to be convinced empirically of their lower cost of capital through transparency in financial disclosure by following IFRS and having their financial statements audited in accordance with ISA. Extensive training of accountants in the use of IFRS and of auditors in the use of ISA is necessary to ensure their application and enforcement.

A second major drawback in the application of IFRS and enforcement of ISA was their non-use by small and medium-sized enterprises (SMEs), given the standards' complexity and high cost for these organizations. Legally, IFRS and ISA are not binding on SMEs, even in countries such as the UK. According to the UK's Companies Act (2009), companies with an annual turnover of less than £6.5 million and fewer than 50 employees are exempted both from following IFRS and having their accounts audited in accordance with ISA. It is estimated that over two-thirds of enterprises in the developed world and over half of these in the developing world are small or medium-sized (using the 50 employee ceiling as the benchmark). Not following IFRS and ISA puts them at a disadvantage compared to larger enterprises in raising capital. This is particularly the case as many SMEs are unlisted and closely held companies. Understandably, banks and other financial institutions would be hesitant to lend to SMEs if they are unsure of the reliability of their financial statements. To address this problem, the IASB issued in July 2009 a special new IFRS for SMEs.[7] This standard, which is explained in Chapter VII, has been designed specifically to cover SMEs' normal financial transactions. This standard was premised on the assumption of SMEs not venturing into exotic off-balance-sheet contingencies like derivatives and special purpose vehicles. Thus far, only South Africa has mandated SMEs in the country to follow this new standard.

In developed countries, the accounting and auditing profession is now subject to fiduciary oversight by an independent agency answerable to the country's legislature. In the US, the Sarbanes-Oxley Act (2002) created the Public Companies Accounting Oversight Board, which prudentially and fiduciarily regulates the accounting and auditing profession and is answerable to Congress. In the UK, the Financial Reporting Council (FRC) has, since 2004, reviewed and assessed the monitoring roles of the professional bodies of

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6 The EU8D on financial disclosure has successfully facilitated the incorporation of IFRS and ISA formulated originally by accountants in common law jurisdictions for the civil law countries of the EU without requiring new legislative approval.

7 IASB. 2009. *IFRS for SMEs*. London: International Accounting Standards Board.

accountants and auditors and is answerable to the House of Commons. Other countries of the Organisation for Economic Co-operation and Development (OECD) have similar regulatory architecture. The era of self-regulation by the accounting and auditing profession ended with the 20th century. However, OECD countries have mature institutions and independent judiciaries to ensure such fiduciary supervision.

## In Transitional Economies

Given the difficulties in complete adoption of IFRS and enforcement of ISA in the developed world, the challenges to their use in transitional economies have been greater. For Armenia, Azerbaijan, and Georgia—three transitional economies from the former Soviet Union—adopting IFRS and rigorously enforcing ISA present a particular challenge, given the nascent stage of development of their legal, regulatory, and jurisprudence systems and the different purposes accounting and auditing served during the era of central planning. The countries' original accounting and auditing systems were designed to provide information necessary for the operation of a centrally planned economy in which state agencies were the only users of accounting information. The prime function of accounting was to monitor and control the use of economic resources to meet planned targets. This system of accounting differed substantially from IFRS in (i) matching costs to revenues, (ii) valuation of assets, (iii) computation of the cost of production, (iv) preference for legal form over substance as the basis for presentation, and (v) treatment of owners' equity. Auditing in a centrally planned economy was reflective of the highly prescriptive nature of the underlying accounting systems. It was limited to an inspection function where compliance with regulation took precedence over truth and fairness. The final accounts of an enterprise were verified with their source booking records. Since enterprises were wholly state owned and their creditors were also the state or other state-owned enterprises, the need for independent financial control and reporting was never appreciated.

Another major and inherent constraint to the creation of rigorous auditing standards has been the conflict between some IFRS and ISA principles on one hand, and the countries' civil codes and tax codes on the other. In some instances, provisions in these laws have impeded the application of IFRS and the enforcement of ISA, particularly in areas such as depreciation accounting, provision of gratuity and pension liabilities, and valuation of foreign exchange denominated assets and liabilities. The origins of this conflict may be attributed to the three countries' socialist civil law legacy, where provisions in the civil code overrode those of other statutes and in socialist times could not be questioned by the courts. The goals of revenue collection are different from the needs of investors, which IFRS and ISA are designed to satisfy. Moreover, as the ministries of finance or the tax committees (which were spun off from the ministries of finance) are also responsible for revenue collection, they have generally allowed the countries' tax codes to override the provisions of their accountancy and audit laws where revenue collections were affected. Although differences between financial and tax reporting are common in developed countries, they are new to accountants and tax collectors in transitional economies.

During the era of central planning, finance ministries controlled the accounting and auditing professions. This was because accounting was limited to a bookkeeping function and auditing was limited to an inspection function, which finance ministries were mandated to perform given their approval powers for funding. This legacy of control continued into the transition era, often on an activist basis. In contrast, OECD countries follow a system in which prudential fiduciary oversight over the accounting and auditing profession is carried out by an autonomous (independent of the executive) agency answerable to the legislature. Such practices need independent institutions to exercise such powers judiciously. Transitional economies do not yet have autonomous institutions, particularly independent judiciaries, to exercise these powers judiciously. The attempt by finance ministries to exercise activist control over the accounting and auditing professions bodes ill for their independence. Investors would place limited reliance on the truth and fairness of financial statements audited by statutory auditors subjected to such controls. It would therefore be in transitional economies' best interests to create separate and autonomous agencies, initially under the overall oversight of finance ministries, but with adequate professional capacity built up through technical assistance both for regulation and for accounting and auditing education and professional entry. Such agencies would help improve the otherwise weak judicial environment and increase the number of qualified accountants and auditors.

During 2000–2009, many transitional economies embarked on reforming their national financial reporting and auditing systems based on IFRS and ISA. Although these efforts have been largely the initiatives of major international financial institutions, the countries themselves have been instrumental in creating momentum, consensus, and capacity.

Soon after their independence, Armenia, Azerbaijan, and Georgia, recognized that their existing accounting and auditing systems were inappropriate for the needs of a market economy, toward which they were moving at varying speeds. Inevitably, the dichotomy created regulatory gray areas that allowed financial irregularities, improprieties, and illegalities in the transitional economies' enterprise and financial sectors. These infractions were undoubtedly exacerbated by weak economic management, poor governance structures, and weak legal and regulatory frameworks. Lack of transparency in financial disclosure was a serious detriment to investor confidence in the countries in transition.

Recognizing the important role of sound and rigorous financial standards in good governance, efficient financial intermediation, and sustainable growth, Armenia, Azerbaijan, and Georgia, with the help of development partners, have undertaken steps to adopt internationally accepted accounting and auditing standards. The next three chapters highlight their progress.[8]

[8] The World Bank's Report on the Observance of Standards and Codes was an important source of data for the TA project's in-country activities and for writing these three chapters.

# III. Armenia

## Financial Reporting Standards

Like other countries of the former Soviet Union, Armenia had no history or tradition of using double-entry accrual accounting systems based on the going concern concept, the conservatism and consistency conventions, and the principle of substance over form. Armenia's current financial reporting is governed by the Law on Accounting of the Republic of Armenia (LARA) enacted in 2002. LARA mandates financial disclosure according to the Accounting Standards of the Republic of Armenia (ASRA), which is based on 2001 International Accounting Standards with minimal modifications. Given the progress of the International Financial Reporting Standards (IFRS) since 2001, most of LARA's provisions are already outdated. It is therefore necessary for Armenia's financial reporting standards to be made IFRS compliant.

IFRS is acknowledged to be complex, difficult to use, and expensive to apply for all enterprises, and therefore a hierarchy needs to be created for its application and use. It should apply initially to large enterprises, financial institutions, and other entities with substantial public interest; but it is not realistic to apply IFRS to micro, small, and medium-sized enterprises (MSMEs).

Armenia has progressed positively in this direction, albeit at a measured pace. In 2008, LARA was amended significantly. Importantly, it requires future amendments of LARA to be IFRS compliant using the precedence of the principle enunciated in the European Union's 8th Directive on Company Law (EU8D) (footnote 6). The amendments also create a hierarchy of reporting requirements: LARA requires all banks and financial institutions supervised by the central bank to have their financial statements prepared according to IFRS effective 1 January 2009; all other large enterprises with revenues exceeding AMD500 million ($1.35 million) will have to follow IFRS from the new financial year commencing after Armenian translations of IFRS are produced. Companies with annual revenues exceeding AMD100 million but less than AMD500 million are required to prepare their financial statements according to existing ASRA.[9] Companies with revenues of less than AMD100 million may continue to use the tax accounting systems—they are exempted from preparing double-entry accrual-based financial statements. LARA requires all published company financial statements to be signed by its chief accountant. Except for banks and financial institutions, the regulator for enforcing companies' compliance with IFRS (or other disclosure standards) remains the Ministry of Finance (MOF). For banks and other financial institutions, the role is performed by the central bank. Inevitably, this could burden the central bank with matters beyond banking supervision.

## Auditing Standards

The Law on Auditing of Armenia (LOAA) governs audits in the country. According to LOAA, the Standards on Audit of the Republic of Armenia (SARA) are based on the 2001 edition of the International Standards on Auditing (ISA) translated into Armenian. There have been no subsequent updates. This has created a significant gap in standards. In November 2009, under ADB's technical assistance (TA) project, updates to

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[9] Armenian law does not legally define a public interest entity.

ISA by the International Federation of Accountants (IFAC) up to March 2009, including its handbook, were translated into Armenian. The MOF intended to enact these updates into SARA by June 2010, using the EU8D principle as a window in the country's civil code. If enacted by June 2010, they would become mandatory from 1 January 2011. Armenia needs to translate future IFAC amendments for integrating them into SARA and for training its auditors in their use. Thus far, unlisted companies, whether public (known as open joint stock companies) or private (known as closed joint stock companies), are exempted from having their accounts mandatorily audited. This deters such companies from undertaking measures internally to improve their financial disclosure and hence lowering their capital costs. The MOF is aware of the consequences of such legislation, which it stated was temporary until further audit capacity in Armenia was built up. Table 1 summarizes the financial disclosure and audit requirements in Armenia.

**Table 1 Armenia's Financial Disclosure and Audit Requirements**

| Type of Entity | Basis of Reporting | Audit Required | Reports Made Public |
|---|---|---|---|
| Open joint stock companies (unlisted) | ASRA (IAS 2001) | No | No |
| Open joint stock companies (listed) | ASRA (IAS 2001) | Yes | Yes |
| Closed joint stock companies | ASRA (IAS 2001) | No | No |
| Limited liability and all other legal forms | ASRA (IAS 2001) | No | No |
| Banks and financial institutions supervised by the central bank | IFRS (current English version) | Yes, using SARA (ISA 2001) | Yes |
| Other financial institutions | ASRA (IAS 2001) | Yes, using SARA (ISA 2001) | Yes |

ASRA = Accounting Standards of the Republic of Armenia, IAS = International Accounting Standards, IFRS = International Financial Reporting Standards, ISA = International Standards on Auditing, SARA = Standards on Audit of the Republic of Armenia.

Source: Compiled by the author and the consultant team leader with reference to the World Bank's 2008 Report on the Observance of Standards and Codes and information provided by the Association of Accountants and Auditors of Armenia.

LOAA underwent amendments in 2004. These related to the practice by and certification licensing of auditors, continuing professional education, and other activities performed by auditors of the MOF.

LOAA does not require auditors to be members of any professional body, though the rationale for this amendment has not been explained. It would, however, reduce the professional diligence of auditors that might otherwise have been exercised by the discipline of a professional organization.

Licenses are granted either to a sole practitioner, or to a partner in a firm, provided that at least half of the partners have a certificate of practice, at least 50% of the firm's capital is provided by such certificate holders, and/or the firm has at least two employees holding a certificate of practice. Such legislation allows dormant partners and non-accountants to team up with practicing accountants to hold offices of profit for probable reasons explained in the next paragraph.

LOAA allows audit firms to undertake non-audit activities, such as accounts preparation, tax advice, asset and liability valuation, and financial analysis. To allow persons with expertise in these disciplines to join an auditing firm, LOAA allows non-holders of certificates of practice to join a firm as partners. However, to avoid the possible conflict of interest of a statutory (external) auditor also undertaking these non-audit functions, a firm of auditors may not carry out audit simultaneously with these ancillary services during the same period. There are also restrictions on "related parties" of the audit firm providing similar services. Such legislation is necessary for a transitional economy such as Armenia, where notions of propriety and avoidance of conflict of interest in governance are nascent. This feature is identical to that in French corporate and accounting and auditing legislation.

## Professional Infrastructure

The current level of capacity in Armenia within the accounting, audit, and compliance areas is low. The country has only one professional body for both accountants and auditors—the Association of Accountants and Auditors of Armenia (AAAA). This association was established in 1997 and was developed with the significant assistance of the United States Agency for International Development (USAID). The AAAA has been an associate member of IFAC since November 2005 and it is in the process of applying for full membership status. The AAAA has 221 members and more than 100 associate members (most of whom are students registered under the AAAA certification scheme). This is out of a total estimated number of 7,000 accountants in Armenia according to the MOF. The AAAA's members are required to pass 40 hours of continuing professional education each year. Members' compliance with this requirement is monitored by the quality control procedure established by the AAAA.

The AAAA has the legal status of a nongovernment organization (NGO). According to the Armenian law on NGOs, the membership of such organizations cannot include legal entities. Therefore members of the AAAA are individuals, not legal entities. This has excluded accounting and auditing companies from membership of the AAAA. Furthermore, the law on NGOs does not allow the AAAA to earn income other than from membership fees; other commercial activity is precluded. This restriction to its ability to generate income is one of the reasons why the AAAA is currently not financially self-sustaining.

Updates to the IFRS released in 2009 were translated by a USAID project in agreement with the MOF in September 2009. However, they have not yet been published as an official package of standards to which LARA can refer. This could be because the MOF intends to adopt a three-level reporting hierarchy including the level of IFRS for small and medium-sized enterprises (SMEs). The USAID-funded project on translating IFRS for SMEs ended in 2009. Certain reform measures on certification and licensing of auditors have important implications for the professional infrastructure (see next section).

## Certification and Licensing Requirements

### Current Practice

LOAA now allows both the MOF and a professional accounting and auditing body to certify and license auditors and to supervise their audit quality.[10] However, for the accounting and auditing body's certification to be valid, its members' examination and other criteria need MOF approval, even if the examinations themselves are conducted by the professional body. Since the AAAA was not named as the professional accounting and auditing body, it is inferred that the MOF may intend to allow the setting up of other rival professional accounting bodies. This measure was described as temporary until ultimately delegated to the professional accounting body. The audit certificate issued is valid for up to 5 years and can be renewed only with evidence that the holder has undergone adequate continuing professional education. Members' compliance with this requirement is monitored through the quality control procedure established by the AAAA. This measure is consistent with standard international practice. Licensing of auditors is carried out by the MOF.

### Proposed Reform

There is a proposal for the further empowerment of the AAAA and a transfer to it of some of the powers currently held by the MOF. Under this proposal, the AAAA will be delegated the power to (i) translate IFRS

[10] For banks and financial institutions supervised by the central bank, this function is shared between the MOF and the central bank.

into Armenian for updating and incorporating into ASRA, (ii) develop IFRS-consistent charts of accounts for companies and guidelines for their implementation, (iii) train accountants in the use of IFRS and the auditors in the use of ISA, (iv) conduct examinations for accountants and auditors, (v) certify accountants and auditors in accordance with IFAC's International Education Standard 8: Competence and Requirements for Audit Professionals, (vi) enforce the IFAC-compliant code of ethics for practicing accountants and auditors to follow, (vii) control the quality of audits performed by its members, and (viii) establish IFAC compliance investigation and disciplinary mechanisms.

Under this proposal, the AAAA will have the right to earn and retain income from the above activities. Membership of the AAAA will be mandatory for practicing accountants and auditors in Armenia. Mandatory AAAA membership could rule out the possibility of establishing rival accounting and auditing professional bodies, as inferred in the previous paragraph. The draft amendment would allow the AAAA to be reconstituted as a professional self-regulatory organization (SRO) by a specific act of the legislature. This act would outline the AAAA's autonomy and define its accountability to the legislature through the MOF. This proposal, if enacted, would help to improve the autonomy of the AAAA, the independence of the accounting and auditing profession, and ultimately the quality of financial disclosure by and audit of companies in Armenia. Importantly, the proposal would help to establish a suitable relationship model between the AAAA and the MOF, creating a public oversight body, which in turn would be accountable to the government.

Such a proposal will strike the right balance between an SRO's autonomy and its accountability in the post-Sarbanes-Oxley Act era. By allowing the AAAA to disseminate new standards by translating IFRS into Armenian and training accountants (and trainers of accountants) in their application, the AAAA will be mandated to ensure that its training of its members results in adequate knowledge transfer. Its supervision and certification functions will help the AAAA realize the efficacy of its knowledge dissemination. Having the AAAA both set and monitor standards could enable it to make the necessary corrections as warranted. Such measures could address both standards and compliance gaps. For its part, the AAAA should admit into its fold accountants and auditors qualified abroad and members of SROs that are already full IFAC members. Doing so would enable the Armenian diaspora to return to Armenia and help to improve significantly the quality of accounting and auditing in the country. The power to license auditors under the proposed legislation would, however, be retained by the MOF.

## Accounting and Auditing Training

Under a previous USAID project, the contractor—the Institute of Chartered Accountants of Scotland—specifically targeted the AAAA's development as a sustainable professional body. Under this project, a certification scheme and certification examinations compliant with IFAC International Education Standards were established. In addition, the Association of Certified Chartered Accountants (ACCA) of the United Kingdom (UK) is another partner of the AAAA.

The AAAA's certification papers and examinations are heavily based on the ACCA's professional scheme papers and examinations. This certification scheme has three levels. The first level has examinations in financial reporting and financial information for management. Passing of the first level could grant the candidate the title of certified bookkeeper. The second-level examination subjects are business taxation, business law, financial management and control, and financial reporting. Passing these examinations grants the examinee the title of certified accountant. The third-level examination subjects are audit and assurance services and information systems. Passing them earns the candidate the title of certified auditor.

Two of the papers—business taxation and business law—have been modified so that they relate specifically to Armenian taxation and law. These papers have been developed in a format compliant with the ACCA's format in order to get exemptions from the ACCA from its own corresponding examinations.

All other examination papers are straight translations of the corresponding ACCA papers. Based on a thorough assessment of the AAAA examinations' content and format, the ACCA granted six exemptions for AAAA students who have passed all seven papers of the AAAA scheme.

The AAAA is also in the process of establishing an experience assessment matrix in addition to final assessment procedures for the candidates for membership.

## Project Outputs

The country workshop was remodeled at the request of the beneficiary and became an intensive 4-day training course with an additional 1-day planning session between the MOF and the AAAA for the preparation of the country action plan.

The project's practical training covered the three areas of financial reporting standards, audit standards, and regulation (compliance and enforcement). In addition, the draft country action plans were drawn up for presentation at the regional seminar.

The target audience selected by the beneficiary was a mix of accountants in industry, auditors, and regulators. The workshop for Armenia was successfully held from 19 to 23 October 2009 in Yerevan and was attended by 41 persons (see Appendix 3 for the list of attendees). Using a mix of case studies and discussions, the workshops covered

- (i) reporting structures for
  - (a) compliance and monitoring,
  - (b) recent changes to IFRS,
  - (c) preparing for audit (by the reporting entity), and
  - (d) detailed consideration of specific standards;
- (ii) audit issues for
  - (a) recent changes to ISA,
  - (b) professional ethics and education,
  - (c) quality assurance, and
  - (d) audit procedures and documentation; and
- (iii) discussions and development of country plans.

The project prepared detailed training materials in modular format. Each module consisted of presentation slides supported by a series of questions and answers (see Appendix 3 for details of the training agenda).

The AAAA issued certificates of attendance and allowed the attendees to count these workshops toward their continuous professional education as required by IFAC membership conditions. This was another positive and tangible output of the project. In addition, the translated training materials were made available for future use by the association.

Additional technical advice was given regarding the structure of the reporting and audit hierarchy, which has resulted in the reopening of discussions regarding the use of the IFRS for SMEs as the second-level reporting requirement.

As part of the efforts to close the standards gap, the project funded the translation of the 2009 edition of the ISA.

## Conclusions and Recommendations

Although Armenia has begun to address some issues involved in the reform of its financial reporting and auditing standards, the following significant challenges remain.

- **The financial statements of many enterprises required to apply IFRS do not reach the required standards.** A review of the financial statements of enterprises shows that enterprises do not or cannot adhere to the quality standards implied by the country's financial reporting standards. It is widely acknowledged that the financial statements produced by Armenian enterprises are generally of poor quality and do not offer a reliable basis for decision making. This is largely due to the lack of capacity of preparers, auditors, and regulators to comply with and enforce IFRS. Lack of up-to-date translation of IFRS has created a training barrier, and the MOF and central bank do not have sufficient capacity to enforce the standards. Furthermore, LARA does not establish sufficient requirements for the certification and competence of professional accountants, and the majority of practicing accountants have no professional qualifications. In the short term, LARA should be amended to require the application of IFRS only to public interest enterprises, hence allowing limited resources to be concentrated in those companies that require higher levels of public accountability. In the medium term, a comprehensive program is necessary to train sufficient number of accountants. Developing the capacity of professional institutes and educational establishments must also become central to a comprehensive training program. Membership of a professional accounting body should be mandatory.
- **The existing audit capacity is grossly inadequate to meet the demands of the large number of enterprises subject to a mandatory audit.** In the short term, the entities subject to a statutory audit requirement should be limited to financial institutions and entities having substantial public interest, and LARA should be amended to make publication of their audit reports mandatory. Medium-term efforts should focus on increasing the capacity of the audit profession through training and strengthening of the AAAA, developing audit methodology and guidance materials, providing an Armenian translation of ISA, and disseminating the code of ethics. The AAAA should be revised to make membership mandatory for all auditors and for the AAAA to be responsible for the oversight of its members. Furthermore, audit standards must be brought into line with ISA, and the AAAA should be given a role in regulating the profession.
- **Developing a tax bridge offering a clear methodology for reconciling accounting and tax profits is critical to the effective implementation of IFRS.** The existing system, in which enterprises are forced either to adhere to tax legislation in the preparation of their financial statements or face the burden of producing separate sets of accounts for financial reporting and tax purposes, is unsustainable. A tax reconciliation process needs to be established to address the potential problems arising in situations where some taxpayers use IFRS as the starting point for calculating taxable profit and others use national accounting standards.
- **Access to the financial statements of enterprises by the public remains very limited, particularly for unlisted companies.** Although large enterprises are required to publish some parts of their financial statements in the mass media, these are not readily available in a usable form. A number of laws govern the publication of financial statements for various forms of legal entities (such as listed, state owned, and private), but the detail and quality of published material is insufficient for the users of financial statements. More stringent enforcement of the laws on publication of financial statements and the establishment of easily accessible repository of financial statements is urgently needed. The creation of an online registry modeled on Companies House (footnote 3) could be helpful in bridging this information gap.

- **Supervision of the audit profession is also not effective because the AAAA's ability to discipline its members is severely hampered.** The AAAA should be empowered with authority to request the MOF to withdraw, suspend, or revoke audit licenses. It should also be given the authority to investigate auditors or audit firms. The MOF should supervise the AAAA prudentially, consistent with the evolving 21st century international consensus regarding audit regulation, which requires public oversight of the audit profession. The law on auditing is being amended to address these weaknesses, and the process should be expedited.

Implementation of the above recommendations must be planned within a time frame consistent with the scale of changes implied and the capacity of institutions responsible for their implementation. The new LOAA under drafting should examine these issues and establish administrative and reporting hierarchies, transferring the quality control and standards setting function to the newly empowered AAAA, while retaining the licensing function. These matters were deliberated at the regional seminar and are reflected in the country action plan for Armenia (Appendix 2).

The analysis and recommendations of the World Bank's 2006 Report on the Observance of Standards and Codes (ROSC) are summarized in Table 2.

**Table 2 Summary of the World Bank's Recommendations in the 2008 Report on the Observance of Standards and Codes**

| Area | Short Term: Year 1, 2008 | Medium Term: Years 2 and 3, 2009–2010 | Long Term: Year 4 plus, 2011 onward |
|---|---|---|---|
| Statutory | 1. Replace ASRA with current translation of IFRS.<br>2. Ensure a sustainable process for the timely translation of future amendments to IFRS.<br>3. Establish a company registry where companies obliged to publish their financial statements are required to file such statements within a defined period of time. | 4. Design and implement a three-tier financial reporting regime.<br>Public interest enterprises should be required to apply full IFRS, SMEs should be required to apply IFRS for SMEs (when available). Micro-entities should be required to report solely for tax purposes. | |
| Accounting | 1. The AAAA should reach out to the universities and students to encourage entry to the accounting profession and membership of the AAAA. | | |
| Auditing | 1. Replace SARA with current translation of ISA and ensure that a sustainable and timely translation process for future amendments to ISA is established. | 2. Review statutory framework for an efficient allocation of responsibility for oversight of the audit profession among the MOF and other bodies (e.g., professional associations of accountants and auditors). | |
| Monitoring and enforcement | | 1. The MOF and professional accounting and auditing associations should further develop the external quality assurance of the audit profession. | 2. Enhance capacity of the MOF and other regulators through training, recruitment, secondment, and twinning. |

*continued on next page*

Table 2 *continued*

| Area | Short Term: Year 1, 2008 | Medium Term: Years 2 and 3, 2009–2010 | Long Term: Year 4 plus, 2011 onward |
|---|---|---|---|
| Accounting and audit profession | 1. The MOF should set out clear and specific criteria which a professional organization must achieve in order to be recognized by the state and given responsibility for certain functions. | 2. The MOF should delegate the performance of its regulatory functions with regard to accountancy and auditing to one or more professional associations that have met its criteria.<br>The delegation of functions could include the qualification of accountants and auditors and audit quality control. | |
| Education and training | 1. Universities should work to enhance their connections with the private sector, regulatory bodies, and professional organizations and should use the input of these entities to make their accounting and auditing education programs more market oriented. | 2. A program to "retrain the trainers" should be undertaken to update the skills and knowledge of educators.<br>3. University syllabi in accounting should be updated and their faculties appropriately resourced and staffed with practitioners and professors with knowledge of the application of accounting and auditing in the practice. | 4. Professional organizations should work closely with universities to allow exemptions from early-stage professional examinations. |

AAAA = Association of Accountants and Auditors of Armenia, ASRA = Accounting Standards of the Republic of Armenia, IFRS = International Financial Reporting Standards, ISA = International Standards on Auditing, MOF = Ministry of Finance, SARA = Standards on Audit of the Republic of Armenia, SMEs = small and medium-sized enterprises.

Source: World Bank's 2008 Report on the Observance of Standards and Codes for Armenia.

# IV. Azerbaijan

## Financial Reporting Standards

Azerbaijan's Law on Accounting (AZLOA) was enacted in September 2004. It mandates the Ministry of Finance (MOF) with implementation responsibility. It initially required all companies in Azerbaijan to follow National Accounting Standards for Commercial Organizations (NASCO), which were based on 1994 International Accounting Standards (IAS). However, banks and other financial institutions are required to follow International Financial Reporting Standards (IFRS).

AZLOA was amended in 2007 to provide for (i) adoption of future IFRS amendments and updated standards directly into NASCO based on the principle of the European Union's 8th Directive on Company Law (EU8D) without requiring fresh legislative approval; (ii) every bank, financial institution, and public interest enterprise (PIE)[11] to follow IFRS from 1 January 2008 onward; (iii) companies, other than banks, financial institutions, and PIEs, to follow NASCO; and (iv) publication of financial statements and auditors' opinions of PIEs, financial institutions, and other open joint stock (similar to public limited) companies on their websites. The MOF is responsible for supervising and enforcing companies' declarations mandated under AZLOA. To reinforce its prudential supervision powers, a Presidential Decree was issued in 2007 empowering the MOF to impose penalties on companies that fail to comply with this legal stipulation. This decree seeks to address the compliance gap.

The MOF is also mandated under AZLOA to translate IFRS updates into the Azeri language and update NASCO to make them IFRS compliant. Azerbaijan benefited from two European Union (EU) projects of Technical Assistance to the Commonwealth of Independent States (TACIS) for the introduction and integration of IFRS into NASCO.

Azerbaijan has also benefited from the World Bank's Corporate and Public Sector Accountability Project approved on 29 February 2008 for SDR7 million. This project supported, among others things (i) establishing under the MOF the Azerbaijan Center for Professional Accounting, Auditing Training Education and Research; (ii) establishing updated accounting and auditing curricula for universities; (iii) training university faculty in such curricula; (iv) establishing accounting and auditing professional benchmarks; (v) developing an Azeri lexicon for accounting and auditing terminology; and (vi) providing for official translation of IFRS.

This external assistance has enabled the MOF to prepare technical commentaries and other training materials under these standards. NASCO is therefore theoretically almost fully IFRS 2007 compliant. There are minor differences in the treatment of deferred tax (under IAS12), and cash flow computation. NASCO has separate standards on the valuation of equity capital of a going concern (there is no counterpart [separate] IFRS). Wisely, every NASCO has an appendix showing its differences with IFRS to enable users of NASCO to interpret them more meaningfully.

[11] A PIE is an entity that meets two of the following three criteria: (i) the average number of employees per year is not less than 1,200, (ii) total annual turnover is not less than AZN30 million ($37 million), and (iii) average assets are not less than AZN100 million ($125 million). Azerbaijan is the only country in the South Caucasus whose accounting law has defined PIE explicitly.

The principal shortcomings in AZLOA are the absence of separate accounting standards for small and medium-sized enterprises (SMEs),[12] and the difficulty of reconciling NASCO with the country's tax accounting requirements.

Since the MOF is the enforcer of AZLOA and NASCO, it is necessary to have a permanent group within the MOF responsible for translation of IFRS and their integration into NASCO. Accountants in the country also need to be trained and educated in the use of IFRS-compliant NASCO, and capacity needs to be built in Azerbaijan for implementing IFRS successfully. The World Bank's Report on the Observance of Standards and Codes (ROSC) recommended continued training of accountants and mandatory continuing professional education to equip accountants with the necessary knowledge.

In the final analysis, Azerbaijan's efforts to move toward IFRS compliance are important steps in the right direction, but significant effort is still needed to achieve the desired goal. The adoption of IFRS for SMEs developed by the International Accounting Standards Board (IASB) in July 2009 could help to address the financial disclosure by SMEs unable to adopt (near IFRS compliant) NASCO. The MOF retains power on accounting regulation, translation of IFRS, compliance with NASCO by companies, and determining standards for non-legal entities.

## Auditing Standards

Azerbaijan's Law on Auditing Services (AZLAS) was enacted in 1994 and amended several times, most recently in 2008.[13] The current law has incorporated updates to the International Standards on Auditing (ISA) up to 2007 and changes to other statutes in Azerbaijan. It covers the administration of arrangement for audit services and the legal bases for its application, and stipulates auditors' rights and duties. AZLAS has mandated both the MOF and the Azerbaijan Chamber of Auditors (AZCOA)—a professional self-regulatory organization (SRO)[14] and an IFAC member—with responsibility for its implementation. Established in 1994, AZCOA had 200 members by 2009, including domestic affiliates of foreign audit firms. AZLAS allows the MOF to delegate to AZCOA the following functions: (i) conducting examinations, (ii) monitoring members' continuing professional education, (iii) controlling entry into the profession, (iv) licensing and regulating of auditors, and (v) quality control of audits. Auditors are currently licensed by AZCOA for 5 years at a time. AZLAS stipulates that the MOF does not micromanage the auditing profession. The MOF has undertaken its mandate diligently, with prudential supervision and control. AZCOA is answerable to the Office of the President of the Republic of Azerbaijan, to whom it reports through the MOF, in the discharge of its legally mandated function. This arrangement maintains the right balance between autonomy and accountability. AZCOA's supervision of the auditing profession needs improvement (see Conclusions and Recommendations). The MOF, as the government's executive branch, assists AZCOA in amending AZLAS according to changing circumstances in the country to promote better corporate and financial governance. AZCOA has drafted, for the MOF's review, further amendments to AZLAS to reflect IFAC's recent changes in ISA and the EU8D. As of February 2010, this draft was being reviewed by the Cabinet of Ministers prior to submission to Parliament. The current reporting requirements for financial disclosures and audit are summarized in Table 3.

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[12] Over 50% of Azerbaijan's registered legal entities are SMEs, which under AZLOA are required to follow NASCO. SMEs find NASCO (with near IFRS compatibility) too onerous to follow, leading to compliance gaps. If the MOF were to allow the country's SMEs to follow the IASB's IFRS for SMEs instead of NASCO, their compliance with IFRS would have been better.

[13] These were based on 1991 ISA.

[14] AZCOA was established in 1994 simultaneously with the enactment of AZLAS.

**Table 3 Azerbaijan's Financial Disclosure and Audit Requirements**

| Type of Entity | Basis of Reporting | Audit Required | Reports Made Public |
|---|---|---|---|
| Public interest entities and financial institutions | International Financial Reporting Standards | Yes | Yes |
| Commercial organizations other than public interest entities and small and medium-sized enterprises | National Accounting Standards for Commercial Organizations (NASCO) | Yes | Yes |
| Budget organizations and municipal organs | National accounting standards for budget organizations | No | No |
| Nongovernment organizations | National accounting standards for nongovernment organizations | No | No |
| Small and medium-sized enterprises | NASCO | No | No |

Source: Compiled by author and the consultant team leader with reference to World Bank documents and information provided by the Azerbaijan Chamber of Auditors.

## Professional Infrastructure

The Association of Certified Accountants of Azerbaijan (ACAA) is the only professional accounting SRO in the country. It was established in 2000 under a grant from the United States Agency for International Development (USAID) as a nongovernment organization (NGO) with 18 members. At its establishment, it was envisaged that it would undertake examination setting, training, certification, and licensing of accountants. The ACAA was granted the status of associate member of the Eurasian Council of Certified Accountants and Auditors to enable its members to receive the Certified Accounting Practitioner or Certified International Professional Accountant certifications. Regrettably, the ACAA did not live up to its expectations. With the ending of the USAID grant, the ACAA was not self-sustaining. It failed to train accountants with knowledge of IFRS revisions as mandated by AZLOA; it failed to conduct examinations successfully; it was unable to effectively and diligently supervise, certify, and license practicing accountants; and there is no SRO comprising a professional body of accountants to effectively supervise the profession and be accountable for its actions. As a consequence of the ACAA's failure to live up to expectations, the MOF assumed these functions (see Financial Reporting Standards section).

## Certification and Licensing Requirements

Azerbaijan's professional certification and licensing system is unusual in that the MOF certifies and regulates accountants and AZCOA performs the same function for the auditing profession. While having a single regulator for the accounting and auditing profession would have been ideal, the existing arrangement, albeit fragmented, provides some balance between accountability and autonomy. The legal framework supporting the auditing profession in Azerbaijan is inchoate and fragmented. AZCOA cannot guarantee the reliability of information certified by auditors, and has yet to develop a transparent procedure for their selection, appointment, and dismissal. This must be clearly defined to establish the objectivity and independence of auditors. The fees for statutory audits and other services provided by the auditors should also be disclosed to ensure auditors' independence. Since AZCOA and AZLAS do not specifically cover these matters, AZCOA should reference them as guidance notes for the intervening period. Substantial training and capacity building of both the MOF and AZCOA are necessary to enable these organizations to undertake their mandates effectively.

## Accounting and Auditing Training

The Association of Certified Chartered Accountants (ACCA) runs some training programs for accountants but is handicapped due to the lack of translated IFRS. The MOF has undertaken some training of its staff in understanding and implementing IFRS. This is reasonable, given that AZLOA mandates the MOF to supervise this function and that the MOF has translated IFRS for use in the country. However, given the complexities of IFRS, and the limitations of the MOF's capacity, substantially more and practical training of MOF staff in IFRS is necessary. MOF staff also need further training in monitoring and enforcing companies' compliance with NASCO.

AZCOA runs examinations to certify auditors. The auditors who pass these examinations are given a license to offer audit services for a period of 5 years. AZCOA has a right to withdraw the license if an auditor is deemed liable in offering lower quality services up to three times during that period. In addition, there is a list of prohibitions that an auditor should not be involved in. Auditors who breach any of these rules have their license withdrawn immediately.

Auditors are required to have continuing professional education every year. AZCOA runs special courses for local auditors for this purpose. Auditors who successfully pass all the courses have their license renewed automatically for 5 years.

## Project Outputs

A reduced 2-day country workshop was held in Baku on 5 and 6 November 2009 (Appendix 3). Its primary purpose was to discuss current accounting and auditing issues and to prepare the country action plan. Current accounting and auditing issues were discussed on the first day and the second day was spent formulating the country action plan.

As part of the effort to close the standards gap, the project also funded translations of the ISA 2009 edition, the Code of Business Ethics for Accountants, and the International Regulations on Audit Experience.

Azerbaijan is relatively advanced in its accounting and audit reforms and has been supported by considerable financing from the EU and the World Bank. AZCOA did not believe it necessary to run the Baku workshop in the same manner as those in Armenia and Georgia. It wished to concentrate on action planning, which was the main output of the workshop, as they had already received sufficient classroom training and the World Bank's Corporate and Public Sector Accountability Project will offer further comprehensive training to members of the profession. It was therefore agreed that three members of AZCOA would participate in the workshop and submit their recommendations on their training to the MOF. This released project funds, which enabled audit standards to be translated and published in book form. The book was officially launched at an event at AZCOA where some 50 people were invited from local auditing companies and representatives of the "Big 4" auditing firms.[15] The event was organized at an official level.[16]

## Conclusions and Recommendations

Azerbaijan's accounting and auditing legislation and regulatory architecture are basically sound. They are indeed the most progressive in the South Caucasus, with potential for calibrated and significant further

[15] The "Big 4" are PricewaterhouseCoopers, Ernst & Young, KPMG, and Deloittes Touche Tohmatsu.
[16] A copy of the book was also sent to ADB's Baku office.

reform. Both are reasonably flexible and have EU8D compliant windows for adoption and integration of future changes in IFRS and ISA. Importantly, Azerbaijan's legislation and regulatory practice provides a balance between autonomy and accountability. This is necessary for sustainable accounting and auditing reforms. Nonetheless, it is essential for Azerbaijan to address the following challenges to improve the quality of its financial disclosure and audit.

- **AZCOA's institutional capacity needs improvement.** The quality of AZCOA's supervision of the auditing profession needs to be improved, particularly the quality of audit, assurance, and codification of auditors' rights and liabilities. This will require extensive training by AZCOA of its members.
- **The MOF's supervisory capacity needs improvement.** Given that the MOF assumed the regulatory and supervisory functions of the accounting profession and corporate compliance with NASCO, MOF staff need to have the conceptual capacity to undertake its mandate. The measures of the World Bank's Corporate and Public Sector Accountability Project (described earlier) are important steps toward improving the quality of financial disclosure.
- **A new regulatory agency needs to be created.** In an ideal situation, the MOF should concern itself with companies' compliance with its corporate governance as stipulated in the country's company law. Certifying licensing and training accountants should ideally be carried out by a professional accounting and auditing SRO, which in turn should be supervised by and be accountable to the country's legislature, either directly (as in the United States under the Sarbanes-Oxley Act, which created the Public Company Accounting Oversight Board), or through a line ministry. Given that AZCOA is already a member of IFAC, empowering AZCOA with the mandate of enforcing application of NASCO by practicing accountants would be worthy of consideration. This is similar to its role in supervising auditors in the application of ISA. Similar to its translation of ISA, AZCOA could also be mandated to translate IFRS. For undertaking this function, AZCOA's members will need considerable training in enforcing the application of IFRS by companies and ISA by auditors. AZCOA has a greater critical mass in this area than the MOF. Consolidation of this function could therefore benefit disclosure standards significantly.
- **IFRS for SMEs is necessary.** Azerbaijan's reform of its financial disclosure and auditing standards has left SMEs behind. Legally, AZCOA requires them to follow NASCO. In reality, however, they are unable to do so, given the complexities of NASCO. This has resulted in a serious compliance gap. Consequently, the MOF has difficulty ensuring SMEs' compliance with these standards. This is exacerbated further by the inability of auditors to apply ISA when SMEs' accounts are not made according to IFRS. The introduction of the IASB's 2009 IFRS for SMEs, initially on a pilot basis, could be a step in the right direction. It would provide SMEs with a benchmark for compliance while improving their disclosure quality, and it would provide an opportunity for auditors to apply ISA in their audits.
- **Developing a tax bridge offering a clear methodology for reconciling accounting and tax profits is critical to the effective implementation of IFRS.** The existing system, in which enterprises are forced either to adhere to tax legislation in the preparation of their financial statements or to face the burden of producing separate sets of accounts for financial reporting and tax purposes, is unsustainable. A tax reconciliation process needs to be established to address the potential problems arising in situations where some taxpayers use IFRS as the starting point for calculating taxable profit, and others use national accounting standards.

- **Access to the financial statements of enterprises by the public remains very limited, particularly for unlisted companies.** Although PIEs are required to publish some parts of their financial statements in the mass media, these are not readily available in a usable form. A number of laws govern the publication of financial statements for various forms of legal entities (such as listed, state owned, and private), but the detail and quality of the published material is insufficient for the users of financial statements. There is an urgent need to enforce the laws on the publication of financial statements more stringently and establish an easily accessible repository of financial statements. The creation of an online registry modeled on Companies House (footnote 3), could be helpful in bridging this information gap.

The analysis and recommendations of the World Bank's 2006 Report on the Observance of Standards and Codes (ROSC) are summarized in Table 4.

**Table 4 Summary of the World Bank's Recommendations in the 2006 Report on the Observance of Standards and Codes**

| Area | Short Term: Year 1, 2010 | Medium Term: Years 2 and 3, 2011–2012 | Long Term: Year 4 plus, 2013 Onward |
|---|---|---|---|
| Statutory | AZCOA must play a more significant role in assisting the MOF in the implementation of reforms<br>Consider deferring the introduction of NASCO until a dissemination program has been undertaken | Consider adjusting the reporting hierarchy and introducing a simplified reporting requirement | |
| Accounting | Sustainable ability to keep the IFRS, etc., current so as to avoid a standards gap | | |
| Auditing | Sustainable ability to keep the ISA, etc., current so as to avoid a standards gap<br>Develop ISA-based audit manual and methodology | Review the statutory framework and establish a public oversight body to oversee the audit function and ensure public accountability<br>Implement effective quality control procedures within AZCOA | |
| Monitoring and enforcement | The monitoring and enforcement function of the MOF should be adequately resourced and made effective | A public registry for joint stock companies should be introduced | |
| Accounting and audit profession | The MOF and professional association should establish a working relationship that will allow professional independence of AZCOA | AZCOA should restructure to allow it to be a self-sustaining body | |

*continued on next page*

Table 4 *continued*

| Area | Short Term: Year 1, 2010 | Medium Term: Years 2 and 3, 2011–2012 | Long Term: Year 4 plus, 2013 Onward |
|---|---|---|---|
| Education and training | An immediate training program should be undertaken to instruct accountants in the use of NASCO<br>Develop a training program for auditors in the application of ISA in the working environment | University syllabi should be updated and made compatible with IFRS and ISA principles<br>Continue the training program for accountants and auditors | The professional association should cooperate with the universities in integrating the training function and allowing exemptions from the professional association's examinations |

AZCOA = Azerbaijan Chamber of Auditors, IFRS = International Financial Reporting Standards, ISA = International Standards on Auditing, MOF = Ministry of Finance, NASCO = National Accounting Standards for Commercial Organizations.

Source: Compiled by the author and the consultant team leader from information extracted from the World Bank's Report on the Observance of Standards and Codes for Azerbaijan, written in 2006 and published in 2007.

Undertaking of these recommendations on a time-bound basis could enable Azerbaijan to actualize the potential benefits made possible by its sound architecture. These matters were deliberated at the regional seminar and are reflected in the country action plan for Azerbaijan (Appendix 2).

# V. Georgia

## Financial Reporting Standards

Georgia's financial reporting standards show a major hiatus between intent and practice. The country's financial reporting is governed by the Georgia Law on Regulation of Accounting and Reporting (GLRAR), enacted in 1999 with inputs from a technical assistance (TA) project by the United States Agency for International Development (USAID) approved in 1996. The GLRAR provided for the establishment of the Parliamentary Accounting Standards Commission (PASC), which is mandated to (i) approve temporary accounting standards not covered by International Financial Reporting Standards (IFRS) but relevant to Georgia for use in the country, and (ii) translate IFRS into Georgian and implement the standards. Under the GLRAR, only PASC was authorized to introduce normative legislation to incorporate IFRS and enforce companies' application thereof. In practice, however, PASC had neither offices nor budget and was therefore unable to carry out its mandate. Consequently, Georgia's accounting standards remain predominantly based on the 1999 International Accounting Standards (IAS). There have been time lags between the issuance of IFRS standards and their adoption as a normative section in the GLRAR. These factors have created a standards gap, which has been exacerbated by the absence of a single agency responsible for prudential and holistic supervision of the accounting and auditing professions, implementation of IFRS, and enforcement of International Standards on Auditing (ISA).

The GLRAR required the adoption of IFRS by banks, financial institutions, and large entities.[17] Other domestic joint stock companies were required to follow temporary Georgian accounting standards. It is inferred that similar disclosure requirements apply to small and medium-sized enterprises (SMEs). Budget-supported and nongovernment organizations (NGOs) have to follow separate disclosure requirements.

Notwithstanding PASC's failure to carry out its mandate, other agencies translated IFRS up to the 2007 version with technical support. ADB's project complemented these efforts by translating the 2008 and 2009 updates into Georgian (see Project Outputs section of this chapter). These ad hoc translations have enabled banks, financial institutions, and other large enterprises with adequate capacity to follow IFRS; however, other enterprises have not been able to do so.

Another major impediment to the adoption of IFRS in Georgia is the compliance gap. This poses more serious problems than the standards gap. The difficulty arises from accountants' lack of knowledge of IFRS, partly because of their conceptual difficulty in understanding accrual accounting. This has resulted in the certification of financial statements as IFRS compliant when in reality they do not comply with the standards. This materially affects the truth and fairness of disclosures in such financial statements, which therefore cannot be used as the bases for rational credit or investment decisions. Georgian financial statements have been known to deviate from IFRS notably in (i) the consolidation of the accounts of affiliated companies; (ii) their provisions for impairment of assets; (iii) related parities disclosure; and (iv) the valuation of property, plant, and equipment. They are therefore fundamentally removed from methodologies followed under all recognized double-entry accrual accounting systems and can therefore not be relied upon.

[17] Georgian law does not legally define a public interest enterprise. In the Georgian context, a large enterprise is defined taxonomically as one having more than 100 employees.

At present only banks, insurance companies, and other financial companies follow standards akin to IFRS. The country's central bank regulates financial institutions' compliance with IFRS and ISA. The State Insurance Supervision Service does the same for insurance companies. Even in banking and insurance companies' financial statements, serious deviations from IFRS have been reported.[18] For nonfinancial undertakings, there is no single regulator responsible for the oversight of company financial statements. Other companies' compliance with IFRS, and even Georgia's own outdated temporary accounting standards, has therefore remained poor.

Georgia's compliance gap is further exacerbated by the country's tax requirements. Like in other countries of the former Soviet Union, Georgian tax law recognizes only cash-based (nonaccrual) accounting, and many companies have followed nonaccrual accounting. The tax authorities have been unwilling to accept IFRS-defined income for taxation or to offer methodologies for reconciling income with tax legislation and IFRS. The MOF of Georgia has no role in determining or implementing financial disclosure standards.

## Auditing Standards

Auditing in Georgia is governed by Georgia's Law on Auditing (GLOA) enacted in 1999. GLOA has abolished mandatory audits for companies except listed ones, large enterprises, and financial institutions. It also abolished the licensing of auditors in June 2005. Where audits are required, they are supposed to follow ISA. In practice, however, there is a gap in standards. The current standard in use is the 2004 ISA. A major effort is underway to translate the current ISA into Georgian for use including under the ADB TA project (see next three sections of this chapter). More importantly, however, there is a significant compliance gap due to the limited use of these standards outside the leading audit firms. In some cases, this compliance gap renders statutory audit virtually useless for the public or investors as a safeguard of the dependability of financial statements. As with the accounting standards, this is more due to a lack of understanding of how to apply the standards than a lack of willingness.

The Georgian Federation of Professional Accountants and Auditors (GFPAA) is the principal self-regulatory organization (SRO) for the accounting and auditing profession in Georgia and is a member of the International Federation of Accountants (IFAC). The other SRO is the Audit Council, which is not an IFAC member (see Professional Infrastructure section). The GFPAA's audit criteria are more stringent than those of the Audit Council. This has created a divergence in the quality of audit reports certified by different auditors. The absence of mandatory audits for all but listed companies, financial institutions, and large enterprises, has reduced the incentive for transparent disclosure. As a result, company financial statements and auditors' reports cannot be relied upon as a basis for rational investment or credit decisions. Georgia's current financial disclosure and audit requirements are given in Table 5.

[18] World Bank. 2007. *Report on the Observance of Standards and Codes–Georgia*. Washington, D.C. January.

**Table 5 Georgia's Financial Disclosure and Audit Requirements**

| Type of Entity | Basis of Reporting | Audit Required | Reports Made Public |
|---|---|---|---|
| Public interest entities, banks, and financial institutions | International Financial Reporting Standards | Yes | Yes |
| Listed commercial organizations other than public interest entities | Temporary national accounting standards for commercial organizations | Yes | Yes |
| Budget organizations and municipal organs | National accounting standards for budget organizations | No | No |
| Nongovernment organizations | National accounting standards for nongovernment organizations | No | No |
| Non-listed companies | Temporary national accounting standards for commercial organizations | No | No |

Source: Georgian Federation of Professional Accountants and Auditors.

## Professional Infrastructure

The GFPAA is the only SRO in Georgia that is an IFAC member. It has 4,540 members. The organization has translated some IFRS and ISA into Georgian. It is also responsible for the education of accountants and auditors and the setting of standards. However, the GFPAA is only one of the organizations that can certify auditors. It requires candidates to undergo 3 years' training to obtain a diploma, and uses the translated syllabus of the Association of Certified Chartered Accountants (ACCA) of the United Kingdom (UK). Another agency in Georgia, the Audit Council, with 600 members, is also empowered to certify accountants, but it has lower barriers to entry. The Audit Council is a Soviet-era relic and is not an IFAC member. The council has certified a plethora of poorly qualified accountants and auditors who continue to practice with their Soviet-era qualifications. The GFPAA can only initiate disciplinary action against its own members and not against those certified by the Audit Council, hence it is essential to introduce rigorous quality control of auditors to ensure high quality audits. This can only happen if the agencies certifying auditors are themselves professionally credible. Moreover, audits are no longer mandatory, except for financial institutions and listed companies, and these exemptions encourage lax standards.

Unlike in the United States (US), with its Public Companies Accounting Oversight Board, or the UK, with its Financial Reporting Council (FRC), there is no external agency responsible for the prudential oversight of the GFPAA in Georgia. Georgia's accounting and auditing oversight has not taken into account post-Sarbanes-Oxley practices in other developed countries. In Germany, the UK, and the US, however, it has been increasingly recognized in the past several years that the accounting and auditing professions need external oversight to avoid members' possible conflict of interest from corporate and financial governance perspectives. This tautology, whose validity is recognized by developed countries, is even more relevant for transitional ones such as Georgia, where independent institutions are still not fully developed. External prudential oversight of the accounting and auditing professions is therefore of utmost importance. Unlike in Armenia or Azerbaijan, the MOF does not prudentially supervise the auditing profession in Georgia.

A new law on accounting and auditing was drafted in 2007. This draft law completely overhauls Georgia's accounting and auditing practice and supervision architecture. It provides for the application of harmonized, IFRS-compliant accounting disclosure standards for all companies in Georgia except SMEs; it facilitates the automatic import of IFRS and ISA updates into the proposed law based on the European Union's 8th Directive on Company Law (EU8D) without fresh legislative approval; and most importantly, it allows only members of professional organizations (who have IFAC membership) to practice as accountants or auditors in the country.[19] Practicing professional accountants under the above criteria will be required to undergo continuing professional education, consistent with IFAC's International Education Standards, conducted by their (IFAC member) professional organization to retain their right to practice. It is inferred that the enactment of this law will disqualify members of the Audit Council. The proposed law reintroduces the necessity for certification and licensing of accountants and auditors abolished under the existing GLOA. This provision regulates entry into the accounting and auditing profession by raising professional entry barriers, consistent with international best practice. Accountants will be certified by their (IFAC member) professional organization subject to their meeting its continuing professional education, ethical, and other requirements.

The law proposes the creation of a new government agency (similar to the Public Company Accounting Oversight Board of the US or the FRC of the UK) with powers to license accountants and auditors, subject to their certification by their professional organization. This new agency will be responsible for the prudential oversight of Georgia's professional accounting and auditing SRO or SROs, thereby maintaining a balance between autonomy and accountability. The law calls for the professional SRO to maintain an electronic list of auditors in the country that it has certified to practice and are licensed by the appropriate authority. This list will be in the public domain. The law introduces ISA-compliant quality control standards and procedures for audits undertaken by members of a professional organization or organizations. The law mandates the organization to have effective mechanisms to enforce compliance of such standards by its members. The SRO in turn will be accountable to the proposed new regulator of its members' adherence to such standards. Such measures were inserted into the draft law to avoid the recurrence of the compliance gap. The law makes it mandatory for all audit companies to have professional indemnity insurance. It also establishes reporting hierarchies to be deferred based on the reporting levels and the standards applicable to each level, and it will determine the level each reporting entity will use. Along with a reporting hierarchy, the law also establishes an audit hierarchy based on the nature of the entity being audited.

In summary, the draft proposed law addresses the important deficiencies in the regulation of Georgia's accounting and auditing professions. By improving accounting and auditing standards, it will increase the value of audited financial statements as a basis for rational investment or credit decisions. Importantly, it seeks to discipline the profession, demanding from it accountability while granting it professional autonomy.

The act's successful implementation will require several inputs. Translations of IFRS by the IASB and of ISA by IFAC need to be undertaken systematically and sustainably. Apart from members' fees, the SRO must disseminate new standards in accounting and auditing to its members expeditiously to avoid a recurrence of the standards gap. This again will require the SRO to charge its members appropriate fees to cover the cost of training. Over the longer term it is necessary to upgrade the syllabus used in the universities in line with new standards, and to train the university professors in these new standards.

Regrettably, the draft law has not yet been enacted in Georgia due to political reasons unconnected with the accounting and auditing professions. It is hoped that the law will be enacted in 2010 and will be ready for implementation to begin 2011. The enactment of the proposed draft law will be an important milestone in enhancing Georgia's accounting and auditing architecture.

## Certification and Licensing Requirements

As has been mentioned, the GFPAA is authorized only to certify its members. The Audit Council, whose qualification standards are lower than those of the GFPAA, was allowed to certify its members. The abolition of

[19] The act defines a professional accountant as a person certified by an IFAC member professional organization.

auditors' licensing in June 2005 allowed members of both organizations to continue practicing as auditors. It is hoped that these issues could be addressed by the enactment of the new law on accounting and auditing.

## Accounting and Auditing Training

The GFPAA offers a Georgian language qualification based on translations of the UK ACCA's 2001 syllabus. In addition, the full English ACCA qualification is available for those with the language skills to take the examination in English. Candidates can qualify as a member of GFPAA by passing the examination of the ACCA of the UK in the English language, or that of the GFPAA in the Georgian language.

As is standard, the ACCA certification scheme has three levels. The first level comprises financial reporting 1 and financial information for management, and offers its passing candidate a certified bookkeeper diploma. The second level offers business taxation, business law, financial management and control, and financial reporting 2, and grants its passing candidate a certified accountant diploma. The third level offers audit and assurance services and is expected to offer information systems, and grants its passing candidate the title of certified auditor.

## Project Outputs

The project provided a 5-day country workshop for the GFPAA. The workshop, which provided intensive explanations of the IFRS and ISA, was held in Tbilisi from 12 to 16 October 2009, and was attended by 23 persons.

Practical training under ADB's TA project covered areas of financial reporting standards, audit standards, and regulation (compliance and enforcement). In addition, the draft country action plan was drawn up for presentation at the regional seminar.

The target audience selected by the beneficiary comprised a mix of accountants in industry, auditors, and regulators. On days 1, 2, and 3, financial reporting issues covered reporting structures, compliance and monitoring, recent changes to IFRS, preparing for audit (by the reporting entity), and detailed consideration of specific standards. Day 4 covered recent changes to ISA, professional ethics and education, quality assurance, and audit procedures and documentation. Day 5 covered discussions and development of country plans. This included technical suggestions regarding the structure of the reporting and audit hierarchy, which has resulted in the reopening of discussions regarding the use of the IFRS for SMEs as the second- level reporting requirement.

The project prepared detailed training materials in modular format. Each module consisted of presentation slides supported by a series of questions and answers (see Appendix 3).

The GFPAA issued certificates of attendance and allowed the attendees to count these workshops toward their continuous professional education, as required by IFAC membership conditions. This was a positive and tangible output of the project. In addition, the translated training materials were made available for future use by the association.

The project team leader also participated in the GFPAA's own conference held in Tbilisi on 5 and 6 November 2009 and delivered two papers on the subjects of financial reporting and audit hierarchies and on compliance and enforcement of financial reporting and auditing of financial reports. Both issues are very relevant to the financial reform situation in Georgia, given that a new law on accounting is being drafted.

Lastly, as part of the projects support to the GFPAA and to assist in closing the standards gap in Georgia, the project funded the translation of the ISA 2009 edition, IFRS for SMEs and an application guide, the 2008 and 2009 IFRS updates, ACCA Financial Reporting, and ACCA Corporate Reporting.

## Conclusions and Recommendations

Georgia's accounting and auditing standards and supervision infrastructure has languished due to gaps in standards and compliance and a lack of prudential supervision. The challenges are summarized as follows:

- **Qualification requirements for accounting and auditing professionals need to be improved.** The continued existence of the Audit Council, notwithstanding its non-membership of IFAC and the right of its members to carry out audits, coupled with the lack of updated standards has created serious standards and compliance gaps. The abolition of licensing of auditors in 2005 has absolved auditors of any professional responsibility and liability. Inevitably, it has lowered the barriers of entry into the profession. As a consequence, the quality of financial statements and audit reports is poor. It is hoped that the enactment of the new accounting and auditing law will address these issues.
- **Access to financial statements of enterprises, particularly unlisted companies, remains limited.** Thus far, only large enterprises and publicly listed companies are obligated to make their financial statements public. At times, even large enterprises' and other listed companies' financial statements made public have not contained information adequate for rational investment or credit decisions. The creation of an online registry of public companies along the lines of Companies House (footnote 3) would be helpful in bridging this information gap. In this respect, simultaneous to the enactment of the new law on accounting and auditing, the government needs to amend its company law to incorporate principles of corporate governance of the Organisation of Economic Co-operation and Development (OECD) into its domestic corporate legislation. Such a measure is necessary to ensure improved corporate and financial governance through the application and enforcement of the new law on accounting and auditing.
- **Developing a tax bridge offering a clear methodology for reconciling accounting and tax profits is critical to the effective implementation of IFRS.** The existing system, in which enterprises are forced either to adhere to tax legislation in the preparation of their financial statements or face the burden of producing separate sets of accounts for financial reporting and tax purposes, is unsustainable. A tax reconciliation process needs to be established to address the potential problems arising in situations where some taxpayers use IFRS as the starting point for calculating taxable profit, and others use national accounting standards.
- **IFRS for SMEs is necessary.** Existing legislation does not specifically require SMEs to follow any standards for the preparation of their financial statements, nor does it require them to be audited. This was justified by the complexities of IFRS for SMEs. It is inferred implicitly that they are required to follow the temporary Georgian accounting standards; however, some SMEs do not follow even these standards. Considering the growing importance of Georgia's SMEs sector, it would be advisable for the GFPAA to introduce the 2009 IFRS for SMEs by the IASB, initially on a pilot basis.

A summary of the analysis and recommendations of the World Bank's 2006 Report on the Observance of Standards and Codes (ROSC) is provided in Table 6.

**Table 6 Summary of the World Bank's Recommendations in the 2006 Report on the Observance of Standards and Codes**

| Area | Short Term: Year 1, 2008 | Medium Term: Years 2 and 3, 2009–2010 | Long Term: Year 4 plus, 2011 Onward |
|---|---|---|---|
| Statutory | 1. Require audit only when there is public interest and capacity allows<br>2. Registration and monitoring for auditors | 3. Make audited financial statements available to public | |
| Accounting | | Professional organization to<br>1. Establish a sustainable translation process for IFRS<br>2. Regulators to revisit relationship between regulatory and general purpose financial reporting | |
| Auditing | | Professional organization to<br>1. Establish sustainable translation process for ISA<br>2. Develop an ISA-compliant standard audit methodology and audit manual<br>3. Make available training courses in the implementation of ISA | |
| Monitoring and enforcement | | Professional organization to<br>1. Establish external quality assurance of the audit profession, linked to registration, and investigations and disciplinary systems subject to independent oversight<br>2. Regulators to adopt internationally recognized principles of accounting standards enforcement<br>3. Regulators to increase resources and investigate any qualified audit opinions on regulated entities | 4. Strengthen the relationship between the regulators and auditors<br>5. Enhance capacity of supervisory authorities via secondment and twinning |
| Accounting and audit Profession | Professional organization to<br>1. Establish a professional qualifications requirement for auditors<br>2. Establish procedures for foreign qualification holders to be registered as auditors | Professional organization to<br>3. Establish an electronic register of statutory auditors<br>4. Continue expansion of membership and scope<br>5. Promote training for "chief accountants" and others | |
| Education and training | | 1. Demand- and supply-side measures to encourage preparers of accounts to improve understanding of IFRS<br>2. GFPAA to bring quality of Georgian ACCA-based qualification close to ACCA standard | 3. GFPAA to establish a recognized mid-stage qualification accessible to all accountants<br>4. GFPAA to work closely with universities toward exemptions |

ACCA = Association of Certified Chartered Accountants, GFPAA = Georgian Federation of Professional Accountants and Auditors, IFRS = International Financial Reporting Standards, ISA = International Standards on Auditing.

Source: World Bank's 2006 Report on the Observance of Standards and Codes for Georgia.

# VI. The Need For Change and The Role of ADB Technical Assistance

## Reform Process

As described in the chapters on Armenia, Azerbaijan, and Georgia, the reform process has involved the rapid introduction of new accounting and auditing standards based on International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA).[20] However, insufficient attention has been paid to the legal, regulatory, and institutional realities in those countries. Despite the reforms of recent years, which have occurred at varying paces in the three countries, the accounting framework for enterprises in these economies continued to be highly prescriptive, taking the form of a fixed chart of accounts and fixed bookkeeping methodologies and procedures. Accounting regulations remained biased toward calculating and collecting taxes rather than managing and evaluating businesses. It was clear that the financial reporting systems in the three countries required more emphasis on enterprises' accountability to stakeholders. Instituting a more effective system of regulation and enforcement and building capacity within the accounting and auditing profession are fundamental preconditions to achieving that objective. This has been particularly challenging in the South Caucasus, given the asymmetries in the reform of their accounting and auditing systems.

The rigorous application of international accounting and auditing standards requires a balanced combination of incentives and deterrents together with effective regulation. Unfortunately, IFRS and ISA themselves do not specify how such regulation should be exercised. This is understandable, given that IFRS and ISA were written by accountants in common law countries—which have the benefit of judicial precedence—and were further developed in the countries of the Organisation of Economic Co-operation and Development (OECD), which have advanced legal and governance standards, many of them following a common law jurisprudence system where judicial precedent provided just solutions for situations that lacked specific legislation. For those civil law countries in the OECD, accounting and auditing legislation is prescriptively detailed to offer accountants and auditors well-established guidelines and benchmarks. The European Union's 8th Directive on Company Law (EU8D) allows for the import into civil law countries through European Union legislation, updates to their accounting standards based on IFRS, and updates to their auditing standards based on ISA without the need to amend their civil codes. Both common and civil law countries in the OECD have independent judiciaries to interpret laws fairly. The existing drafts of international accounting and auditing standards implicitly assume the existence of similar legal, institutional, and policy conditions, which are underdeveloped or absent in transitional economies given their nascent regulatory and governance frameworks. This is exacerbated by the absence of independent judiciaries in the former centrally planned states to interpret and apply laws fairly.

Furthermore, when Armenia, Azerbaijan, and Georgia commenced their transition in the late 1990s, the critical mass of knowledge on how such a transition should be attempted was lacking, as was an

[20] ADB's role under TA 6505-REG: *Enhancing Financial Disclosure Standards in Armenia, Azerbaijan and Georgia* was very similar to that under TA 6249-REG: *Enhancing Financial Disclosure Standards in Transitional Economies*. See publication with the same title by R. Narasimham and E. Adhami (2008).

understanding of the time frame in which it could be achieved. The organic development of the accounting systems of developed economies has been a gradual evolutionary phenomenon occurring over decades. The time taken was considerable, even in countries where there is significant international exposure, a highly developed accounting subculture, and independent judiciaries. In the United Kingdom (UK), for example, despite a developed accountancy profession and the establishment of an accounting standards committee in 1970, the concept of harmonization with International Accounting Standards (IAS) was not part of UK policy until the establishment of the Accounting Standards Board in 1990. The problem of slow development is even more severe in transitional economies, where accounting and auditing professionals were isolated from accounting developments in market economies. Moreover, as Armenia, Azerbaijan, and Georgia are non-English-speaking countries, there has inevitably been a time lag between the emergence, or updating, of IFRS and their translation into local languages. This inevitably creates a standards gap.

Given the lack of capacity, it is not surprising that the accelerated introduction of IFRS-based accounting standards in transitional economies has led to a situation where, in the majority of cases, the adoption of IFRS is merely nominal (i.e., more marked in form than in content), and the accounting and reporting practices of enterprises are materially unchanged. This has created the compliance gap. Such a practice is undesirable as it has the potential to substantially compromise the truth and fairness of financial statements that are supposedly prepared under IFRS and audited according to ISA. Although important steps have been taken toward introducing international financial reporting and auditing standards, formidable challenges remain in building legislative and institutional capacity to regulate and enforce the application of those standards by accountants and auditors.

Armenia, Azerbaijan, and Georgia have experienced common problems in implementing IFRS and ISA effectively. Useful lessons can be learned from the successes and shortcomings of their recent reform efforts.

## Impact of the Project on Enhancing Financial Disclosure

The expected impact of this technical assistance (TA) project was to bring about quality improvements and compliance with accounting and auditing standards in Armenia, Azerbaijan, and Georgia in line with IFRS and ISA. It focused predominantly on companies in the nonfinancial sector and on enhancing regulators' capacity to set accounting and auditing standards, implement quality control measures, and enforce compliance where necessary. This was ADB's first intervention in this sector in the Caucasus.

Country workshops were organized to ensure that the regional interface sought under the TA project complemented, and did not replace, the envisaged country-specific focus. The regional seminar was instrumental in facilitating debate on common problems and sharing experiences among countries.

The TA project specifically concentrated on (i) providing methodologies for addressing legal and regulatory impediments to the application of IFRS and ISA; (ii) training regulators on the updated IFRS and ISA; (iii) providing methodologies for reconciling income and asset values computed according to IFRS standards with those computed according to local tax regulations; (iv) providing specific guidelines for interpreting and implementing IFRS and ISA; (v) recommending criteria for entry and continued membership of the profession; (vi) translating auditing textbooks, ISA, and other updated relevant material into local languages, without duplicating what has already been translated under projects by the United States Agency for International development (USAID) and other TA projects; and (vii) after completion of the country-specific training programs, conducting a regional seminar to provide an interface for the regulators from the three countries to share their knowledge in applying IFRS and ISA.

The following six points provide an overview of how the TA project contributed to achieving these objectives.

## Providing Methodologies for Addressing Legal and Regulatory Impediments to the Application of International Financial Reporting Standards and International Standards on Auditing

A necessary condition for the application of IFRS and the enforcement of ISA is the existence of appropriate legal, institutional, and policy conditions that are absent or nascent in transitional economies. Exacerbating the situation is the absence of mechanisms in most of the transitional economies for public oversight of the audit function, including the setting of auditing standards and the assurance of audit quality. As a result, there is high reliance on international audit firms and their national members to compensate for weaknesses in domestic regulatory regimes. This reliance is risky, however, as audit by a local affiliate of an international audit firm does not guarantee high quality. The real determinant of audit quality remains the strength of the domestic regulatory regimes, rather than network membership. Rigorous application of international accounting and auditing standards requires effective regulatory and enforcement frameworks that are applied and administered consistently.

The need to strengthen prudential regulation and oversight is urgent and common to all the transitional economies that have adopted IFRS and ISA. It is essential to address legal and regulatory impediments to the application of IFRS and the enforcement of ISA. Activist over-administration coupled with under-regulation by ministries of finance can be counterproductive. This project was a step toward bringing together regulators, standards setters, and professionals from the three countries to raise their awareness and offer them a forum to debate common issues and problems.

The TA project reinforced the need for national and international organizations to agree on a comprehensive framework for regulating the accounting and auditing professions, which national authorities would then adopt within their borders.

There is also little evidence that company financial statements or information thereon are made available to the public in a systematic way in any of the three countries. The financial statements that are available frequently suffer from deficient disclosures and do not fully adhere to international standards, limiting their value to shareholders, investors, and the public. From an accounting perspective, this contradicts the very essence of IFRS and adds significantly to the cost of investing in the transitional economies. Providing access to corporate financial statements was stressed throughout this project as a means to protect third parties such as creditors, suppliers, and employees and to alert the public to potential economic problems that may result from financial difficulties faced by economically significant public enterprises.

Extensive coverage of regulation and enforcement issues was provided at the country workshops by presenting information about the regulatory systems of other countries, particularly the UK, where the system covers a wide range of areas including (i) legislation, (ii) standard setting, (iii) monitoring the work of accountants and auditors, (iv) enforcing compliance with accounting and auditing standards, and (v) enforcing the publication of financial statements.

In developed countries, the basic legislation governing companies has existed for many decades. In the UK, for example, this legislation sets out (i) the requirements for the charter of a company; (ii) the rules of conduct for a company with respect to meetings, corporate reporting, shareholders rights, and directors' responsibilities; (iii) the rules prescribing the format of financial statements and the basic accounting principles to be applied; (iv) the audit requirements for the various types and sizes of companies; and (v) the requirements for publishing financial statements and other information (the charter, the list of shareholders, details of directors, any secured loans, etc.). By contrast, in transitional economies, corporate legislation is of recent origin and the principles of corporate governance are still nascent.

The country workshops offered the opportunity to contrast the development of accounting and auditing standards and the legislative and institutional frameworks supporting their enforcement in the three countries with those of the UK. For example, the first accounting and auditing standards were introduced in the UK in 1969 after a number of publicized commercial scandals. Standards were initially set by a joint body representing the accounting and auditing associations before an independent body was established to set standards and monitor the quality of financial statements. A few years later, the Department of Trade and Industry created the Financial Reporting Council (FRC) to set accounting and auditing standards in the UK.

As for auditing, UK auditors are required to be licensed by one of the accounting and auditing associations; and since 2004, the FRC has monitored auditors acting for public interest entities. The FRC also reviews and assesses the monitoring role of the professional bodies over the remaining auditors.

The FRC, as an independent body, plays a central role in enforcing compliance with accounting and auditing standards in the UK, including monitoring financial statements and auditors to ensure compliance with accounting and auditing standards. Such independent institutions do not yet exist in Armenia, Azerbaijan, or Georgia. The ministries of finance of Armenia and Azerbaijan continue to play governing roles albeit of different magnitudes, and Georgia has no single authority to regulate the profession prudently. The role of professional organizations is also limited given their small memberships and lack of capacity and resources.

Furthermore, all three countries lack a single repository of corporate information, such as Companies House, where company financial statements can be lodged for public access. Companies House has existed for decades and all public limited companies are obliged to submit annual financial statements and other information. For a small fee, Companies House will provide information about any company in the UK, including a copy of its financial statements, details of directors and shareholders, and the charter.[21]

The three countries showed significant interest in the structure of the FRC and Companies House. Full information was furnished at the country workshops to prepare for the regional seminar in Tbilisi, where participants explored the implementation of similar structures in transitional economies with representatives of the FRC and Companies House.

Georgia's participants acknowledged that nonobservance of accounting and auditing legislation is widespread in the country and that there is insufficient compliance monitoring. The situation is made worse by inconsistencies in the various normative and legal acts that need harmonization. They noted that the draft of the new law on accounting and auditing, if enacted, would address the problems faced in financial disclosure and auditing.

Armenia's participants recognized the importance of IFRS-compatible, transparent accounting standards, and auditing standards in line with ISA. The Ministry of Finance (MOF) of Armenia presented its proposal for empowering the Association of Accountants and Auditors of Armenia (AAAA) to conduct examinations, certify auditors, and enforce International Federation of Accountants (IFAC)-compatible quality control on audits and disciplinary mechanisms over auditors. The MOF would, however, retain the power to license auditors. A representative of the MOF believed that the concept of a regulator of the accounting and auditing professions that is independent of the MOF was incompatible with its existing governance structures.

Azerbaijan's participants believed that their country's accounting and auditing regulatory architecture was appropriate to its present needs and has the flexibility for further reform. It provides the Azerbaijan Chamber of Auditors (AZCOA) with autonomy coupled with accountability, striking a balance between the two. Its hierarchy for financial reporting and auditing is also balanced.

Participants from Azerbaijan and Georgia at the domestic workshops and regional seminar favored the creation of autonomous regulatory boards in their countries (like the Public Companies Accounting Oversight Board in the United States and the FRC in the UK) to supervise the accounting and auditing professions on a fiduciary and prudential basis, answerable to the legislature. Armenian participants from the AAAA also endorsed this view. Participants agreed that vesting powers arbitrarily with the MOF to supervise the

[21] In 2006, Companies House dealt with 5 million requests for such information.

accounting and auditing professions could render them over-administered but under-regulated. This could be counterproductive. The country participants also recognized that such an evolution would take time and would require significant resources, given the nascent legal structures coupled with the absence of the principle of judicial precedent needed to determine appropriate and fair regulation by the independent regulator in areas not specifically legislated.

Furthermore, the participants accepted the speakers' suggestions on the (i) enactment of Sarbanes-Oxley Act-type legislation, mandating responsibilities for auditors and corporate managers; (ii) fiduciary oversight of the accounting and auditing professions; (iii) creation of public companies' information repositories; and (iv) effective enforcement to enhance corporate governance standards in their countries.

## Training Regulators on the Updated International Financial Reporting Standards and International Standards on Auditing

As discussed in Chapters III to V, the national accounting and auditing standards in the three countries are based on earlier versions of IFRS and ISA, which these countries adopted as their national standards. The 2003 translations are now significantly outdated but are still widely used. Many regulators in the three countries are unfamiliar with the recent drafts of IFRS and ISA, and this limits their ability to update their national standards.

The country workshops were the main forum for training regulators on the updated IFRS and ISA and their associated regulatory regimes. Three 1-week workshops were held for a total of 47 participants representing a wide range of regulatory bodies—accountants, auditors, professional associations, accounting policy departments of ministries of finance, stock exchanges, tax authorities, financial supervision agencies, and universities.

The workshop content was based on the stakeholders' requirements, which had been articulated through meetings in each country. Although the basic material was the same, each workshop contained country-specific sessions. The range of topics covered (i) regulatory regimes, (ii) relevance of IFRS, (iii) fundamentals of IFRS, (iv) monitoring changes in IFRS (2001 to 2009), (v) IFRS versus national standards, (vi) accounting for tax, (vii) monitoring changes in ISA (2001 to 2007), (viii) audit reports, (ix) audit sampling, (x) professional membership, (xi) financial instruments, (xii) code of ethics, and (xiii) quality control.

Some materials were developed for the individual countries based on their specific needs and stage of development (e.g., sessions on specific IFRS, such as those governing financial instruments). All workshop materials were distributed to the participants on CDs.

At the country workshops, training was provided on IFRS using practical case studies. Training was also provided on the IFAC auditing handbook, covering ethics and quality control. For auditing standards, three case studies were presented which together covered most of the 31 standards. The documentation and discussion of the changes to IFRS (Appendix 4) and ISA (Appendix 5) from 2000 to 2009 also provided a strong technical foundation throughout the workshops.

An important objective of the country workshops was for each country to prepare a draft action plan for reform. In this respect, the project has been instrumental in helping the beneficiary countries draw up country action plans (Appendix 2) that offer a clear way forward in developing their accounting and auditing systems and the regulatory framework. Although the quality of the plans developed at the workshops varied, they were refined and greatly improved at the regional seminar in Tbilisi.

The level of workshop participation was high and the overall feedback was positive, confirming the need for such gatherings on a regular basis. The workshops were perceived as directly relevant to the participants' work, despite the wide range of disciplines and backgrounds represented. The workshops focused on practical scenarios and examples in the context of the history and development of the accounting and auditing professions. The feedback on the depth and breadth of the workshops was mixed, which was expected given the short duration of the workshops and the varied background of participants. By far the most common suggestion from the participants was that such workshops should be held at least annually. Considering the importance of such events in molding bureaucratic and legislative opinion in favor of reforms, it is surprising that they are not regularly organized by the national authorities.

### Providing Methodologies for Reconciling Income and Asset Values Computed According to International Financial Reporting Standards and those Computed by Local Tax Authorities

Taxation is an important matter that is linked to the process of accounting. There are two areas where taxation and accounting are linked: (i) the calculation of taxable profit, which requires transactions and events to be recorded in a way that allows the tax rules to be followed; and (ii) the recognition in financial statements of the liability to pay taxes in both the current reporting period and future periods based on the situation existing at the end of the reporting period.

A common problem encountered by accountants preparing IFRS financial statements in transitional economies is that the profit calculated under IFRS is unlikely to be the same as the taxable profit calculated under the taxation rules.

Profit calculated under IFRS is required to be "fair"—which is by nature difficult to define, as what is considered fair will depend on the circumstances. Fairness is a value judgment. Historically, fairness evolved from the concept of conservatism and, in common law jurisdictions, on judicial precedents. The evolution went from a concern with liquidity and creditor protection to a concern that financial statements should be fair to all users. Fairness is best understood as an expression of neutrality in the preparation of financial statements, which is an unfamiliar concept in transitional economies. Exercising it requires significant judgment skills that many accountants in the three countries still do not possess.

On the other hand, profit calculated for taxation purposes is not neutral. The rules of calculation are set to allow profits to be verified as "correct" (in accordance with legislation) rather than "fair," and do not allow for applying a high degree of judgment. In fact, a government may have any number of economic objectives embedded in its fiscal and taxation policy, as evidenced by its tax code. Accounting fairness is seldom a canon for fiscal policy. In transitional economies, accounting standards are generally biased toward taxation rather than jurisprudent fairness.

Experience in other transitional economies suggests that discrepancies between taxable profit and accounting profit form a significant barrier to substantive accounting reform. The current situation—in which enterprises are forced to either adhere to tax legislation in preparing their financial statements or face the burden of producing separate sets of accounts for financial reporting under IFRS and tax purposes—is unsustainable. The conflicting requirements of IFRS and the tax authorities therefore remain a serious impediment to implementing IFRS and have yet to be effectively addressed.

To offer a methodology for tax reconciliation, this project first identified the main differences between the treatment of profit tax under the national tax codes and under IFRS. A comprehensive tax reconciliation manual was then prepared showing how to account for differences between the tax codes and IFRS (Appendix 1). A comprehensive tax case study was developed, based on the issues arising in each country. The same case study was used for all three countries, and solutions were prepared according to the tax code of each country.

The manual is a step-by-step solution to the case study, which deals with a company in its first 2 years of trading. The tax manual also includes lecture notes, slides, examples, and case studies used in the country workshops. The entire package was designed to offer comprehensive and quality materials as the basis for designing and delivering a 2-day training course titled IAS 12: Income Taxes.

The publication of the tax manual was timely, as all three countries were either introducing IAS 12 or developing a system for assessing compliance with IFRS. Compliance with IAS 12 is an important indicator of compliance with IFRS.

The development of a tax bridge offering a clear methodology for reconciling accounting and tax profits is critical to the effective implementation of IFRS, and its development is a priority for the three transitional economies. The comprehensive tax reconciliation manual, developed under the earlier TA project for Central Asia and used for this project, offers a methodology for dealing with differences between profits calculated under tax rules and those calculated under accounting standards.[22]

## Providing Specific Guidelines for Interpreting and Implementing International Standards

The implementation of IFRS and ISA in the three countries is hampered by a few related issues, such as delays in the availability of guidance materials in local languages and the limited capacity of the agencies responsible for the development and publication of standards. A serious impediment to progress is the delayed availability of official translations of IFRS and ISA in the local languages.

A related problem is the general lack of capacity within the state institutions responsible for developing and disseminating accounting and auditing standards. Although technical assistance by donor agencies has been instrumental in relieving the problem in the short term, sufficient budget financing has not yet materialized to effectively address the problem in the longer term. As a result, there are limited resources available within the three countries to keep the national standards updated to the required quality, let alone to produce or update any supporting guidelines. The problem is unlikely to be resolved quickly, as many standard-setting institutions, such as the MOF, offer low public sector salaries and cannot attract qualified staff with internationally recognized accounting qualifications.

Producing country-specific guidelines to support accounting and auditing standards would have been an enormous undertaking, and the output would have had a limited shelf life given the changes planned for ISA and the general movement from national standards toward IFRS. Instead, relevant guidelines and materials already in the public domain were compiled and made available to each country. In addition, guidelines were produced for items for which there was a specific need, and particularly those that were relevant to all three countries. The supporting materials for the interpretation of IFRS guidelines and the implementation of ISA guidelines are as follows:

### International Financial Reporting Standards Guidelines

The IFRS book runs to over 2,400 pages. While the basic 12 standards remain very important, it is unrealistic to expect a general accountant or auditor to have a sound knowledge of the other 25 standards and the 18 interpretations. For this reason, IFRS has in part become a reference document. Annual update courses still play a part in continuing professional education if the changes relate to mainstream areas.

The experience of implementing IFRS in the region indicates that it is prohibitively expensive and time-consuming to produce country-specific guidelines and to keep them up-to-date. Therefore, ADB's TA project financed the translation of IFRS and ISA, as needed, from its budget.

A detailed analysis of all the changes to IFRS from 2000 to 2009 (Appendix 4) was also created, including explanations of the reasons for the changes and a review of potential changes in the pipeline. This input was valuable in helping the three countries bring their national standards into line with the latest IFRS.

[22] An example from Uzbekistan (a paradigm in transitional economies for tax treatment) demonstrated under ADB's TA project *Enhancing Financial Disclosure Standards in Transitional Economies* was replicated under this TA project and is provided in Appendix 1.

## Guidelines for International Standards on Auditing

Compared to IFRS, the situation with respect to ISA is more complex. Accounting is arithmetical, with clear rules and an end product, and can be learned largely through education and practice. In contrast, auditing is a practical discipline where on-the-job training is essential. The IFAC auditing standards were drafted in the 1980s, instigated by the then "Big 8" audit firms,[23] each of which had already developed its own detailed audit methodology. Consequently, the standards were written so as not to contradict any of the eight different methodologies. Although this served the purpose of the large auditing firms, it is fair to say that the resulting standards were not written to be of practical use to someone conducting an ISA audit for the first time.

When auditing became more formal in the 1970s and training became important, the Big 8 developed "model audit files" based on real clients to demonstrate the standard of work that was expected. They also devised standard documentation (audit programs, internal control checklists, etc.) to direct, control, and monitor the work carried out by their auditing staff. All this developed into the detailed audit methodologies that are in general use in the large audit firms.

The audit profession in the three countries has little past experience and there is unlikely to be a cohesive framework of supporting practical documentation to guide the audit work. Consequently, there is a very steep learning curve, which constrains the development of audit capacity in transitional economies. This challenge needs to be addressed by intensive study of IFAC auditing standards for their adoption in these countries.

The national auditing standards in the three countries are based on various versions of ISA from 2001 to 2006 and suffer from inconsistencies. Most importantly, the IFAC auditing standards, which run to some 1,000 pages, will be significantly rewritten over the next 3 years and the production of a comprehensive audit guideline is also planned. Given the current circumstances, the value of developing country-specific guidelines was questionable, as any guidelines developed would become quickly outdated. Instead, the countries were advised that their resources would be better spent establishing a sustainable translation capacity and fully adopting ISA as their national auditing standards.

Clearly, more time is needed to strengthen the capacity of the audit profession in the three countries and to implement appropriate quality assurance processes. Since new standards are unlikely to be issued until 2011, this allows sufficient time to achieve this with support from the government and professional organizations. A description of changes in ISA from 2000 to 2009 is given in Appendix 5. At the current stage of the audit profession's development in these countries, audit manuals and practical audit documentation, including model audit files, are urgently needed. An audit manual is less subject to frequent amendments than auditing standards, and hence offers a more stable tool. Although the current Big 4 auditing firms have such manuals, among smaller national firms those with auditing manuals are the exception.

At the country workshops, the purpose and use of an audit manual was discussed, and the workshop participants appreciated the manual's value and relevance. The production of an audit manual could be pursued through further TA projects.

The regional seminar participants suggested that the big international audit firms should make their audit manuals more generally available to others. However, a representative of one of the large firms explained that such manuals are developed and maintained at great commercial expense and have limited value without formal and on-the-job training in their application. It was also pointed out that in developing countries it is the professional institutions' role to prepare such materials and conduct training, and that the three countries should direct more effort and resources toward developing the capacity of their professional institutions to fulfill that role.

[23] The "Big 8" refers to Arthur Young, Ernst & Whitney, KPMG Peat Marwick, Deloitte Haskins & Sells, Touche Ross, Price Waterhouse, Coopers & Lybrand, and Arthur Andersen.

### Recommending Criteria for Entry and Continued Membership of the Profession

The lack of capacity in the beneficiary countries suggests that the accounting profession should be opened up more to practicing accountants from developed countries using IFAC, but this creates a political dilemma. Before the country workshops, meetings were held with professional associations to discuss the current criteria for entry and continued membership for accountants and auditors, any plans for future change, and the changing role of governments (most noticeable in Azerbaijan).

At the country workshops, membership criteria of several regional associations were contrasted and discussed, in addition to the membership requirements and structure of international bodies, such as the Institute of Chartered Accountants of Scotland, the Association of Certified Chartered Accountants (ACCA), the American Institute of Certified Public Accountants, and the Australian and Canadian professional associations. The membership criteria and a reciprocal agreement between associations from the same country were also explored. Furthermore, discussions were encouraged about the length of practical experience required for membership in a transitional economy and how the quality of practical experience is more relevant than the length. The current experience requirement of 5 years may exclude able and experienced accountants and auditors, whose contribution to a professional association could be substantial. This may also contribute to the differences between accountants and auditors working for local firms and those working for the Big 4, which is detrimental to professional associations. Furthermore, the 5-year experience requirement may deter some of the best university graduates (i.e., those with alternative career opportunities) from entering the profession. During the current transitional period, when capacity is so lacking, more flexible strategies should be in place to recruit the very best people into the profession.

The entry requirements of the national associations appear to be set, and there seems to be little scope for developing a common regional standard. Also, the need for open and inclusive membership during the transitional period conflicts with the IFAC guidelines and the general desire of the associations for exclusivity in their membership. There are strongly held views that potential members should have relevant degrees and work experience. All three countries recognized IFAC's ISA as the anchor to which they should benchmark their auditing standards.

### Translating Auditing Textbooks, International Standards on Auditing, Code of Ethics, and Other Updated Relevant Material into Local Languages, Avoiding Duplication

As discussed throughout this publication, effective implementation of international standards is hindered by a lack of up-to-date translations of relevant guidance materials into the local languages. This TA project financed the translations from its budget.

Detailed materials on the code of ethics were translated and presented at the country workshops, including case studies to demonstrate its application in situations relevant to the three countries. Furthermore, an analysis of all the changes in ISA from 2000 to 2009 was prepared to allow each country to bring their national standards into line with the latest ISA.

## Lessons Learned and Common Features

The principal lessons learned in the introduction of IFRS and ISA by the three countries were as follows:

- The rigorous application of international accounting and auditing standards in transitional economies is impeded by a lack of capacity and institutionalized incentives (both positive and deterrent).

- Accounting and auditing regulation is critical for underpinning such incentives, but the international accounting and auditing standards themselves do not set out requirements for how regulation should be exercised.
- IFRS and ISA are not appropriate for all sizes of enterprises; their application should be mandatory only for economically significant enterprises where there is a high level of public interest in their financial performance.
- Lack of human and financial resources is a significant impediment to implementing international standards, and resources committed by national governments and businesses are grossly inadequate for redressing the situation.
- Mechanisms for public oversight of the audit function, including the setting of auditing standards and procedures for assuring audit quality, are almost entirely absent in many transitional economies.
- There are inherent limitations to the extent of reliance that can be placed on international audit firms and their national member firms to compensate for weaknesses in domestic regulatory regimes.

The following common features were observed in Armenia, Azerbaijan, and Georgia:

## Standards Gaps

Standards gaps arise because of an inability to maintain up-to-date translations of international standards—typically of IFRS and ISA—but gaps can also arise due to state regulations that contradict IFRS. Typically, countries in the region have relied on external donor funding to provide translations and they lack the ability to maintain standards sustainably. It is not sufficient simply to pass a law requiring a state organ or other party to translate the standards; adequate resources must also be provided. In reality this is usually the easiest of the three gaps to close.

## Compliance Gaps

Compliance gaps usually exist where the law does not require such monitoring, or where—as in the case of Azerbaijan—there is a provision in law but no resources have been provided to create this capacity. The use of IFRS in financial reporting and ISA in audit is not effectively enforced. Effective enforcement is crucial to the whole process. It is not sufficient simply to pass a law requiring a state organ to monitor compliance; it is also necessary to adequately resource this activity. Compliance gaps also arise in both financial reporting (accounting) and auditing. Typically they arise because of a lack of capacity. The standards are not correctly applied basically due to a lack of technical knowledge and/or a lack of physical capacity. There is a general shortage of skills and/or a shortage of technically competent practitioners in the auditing profession and the industry. This can be compounded in situations where reporting and audit requirements do not match the needs of the reporting entities.

## Reporting Hierarchy

Since 1995, many international organizations and donors have concentrated solely on the introduction of IFRS. In so doing, they have in effect ignored the bulk of the transitional countries' economic activity, which is contained in commercial organizations that are far smaller than would be required to use IFRS and are of little or no interest to the public.

IFRS is extremely complex, difficult to use, and expensive to apply, and it is only intended for use by very large entities—typically public interest enterprises (PIEs) and larger government business enterprises. IFRS consists of over 2,400 pages of often complex and technically demanding instructions, in contrast to the new IFRS for SMEs (Chapter VII), which has 264 pages. It is also subject to frequent change and modification. Problems have arisen in the region in applying IFRS to SMEs, enterprises that are clearly not PIEs.

A variation of this problem has been the introduction of national accounting standards that are too detailed, as is arguably the case in Azerbaijan. National standards for SMEs are in effect closer to the full IFRS than the more appropriate second-level reporting standards (IFRS for SMEs). Preparers of the financial reports have been found to be not technically qualified to apply the standards.

Application of ISA requires a level of resources that is not available in transitional economies, and, as with IFRS, audit standards are complex and subject to ongoing change. For example, in Armenia, there are only 150 holders of the MOF accounting qualification and 75 holders of the audit qualification, but the law requires all entities to be audited in line with ISA. This clearly highlights two issues: the lack of professionally qualified auditors, and the law's requirement for auditing of too many of the smaller entities. A calibrated hierarchy of entities that should follow IFRS and those that need not follow IFRS should be delineated, at least until such time as the IFRS for SMEs is introduced.

### Inability to Maintain Standards in Line with International Financial Reporting Standards and International Standards on Auditing

The lack of capacity and affordability in the three countries to translate IFRS and ISA creates logistical difficulties for their implementation. ADB's TA project has identified standards gaps in all three countries, e.g., IFRS published on the Azerbaijan's MOF website need updating to meet the requirements of the European Union's 8th Directive on Company Law (EU8D), adherence to which is mandated by current Azerbaijani legislation.

### Certification and Licensing of Accountants

This can be a very contentious area as it can involve the transfer of powers from the state to the professional organizations. Given the three countries' governance systems, it is desirable that certification of accountants is done by competent professional associations, whilst licensing is done by a state body, subject to auditors having been certified by a professional SRO and IFAC member.

### Lack of Established Working Systems for Enforcing Compliance

Good corporate and financial governance requires the enforcement of legally mandated requirements of financial disclosure and audit. With the exception of banks and financial institutions, there appears to be little effective enforcement of compliance in any of the three countries. Enforcing stringent compliance with the reporting requirements under IFRS and ISA is a more complex problem. In this context, a calibrated hierarchy for standards of reporting and audit could help smaller entities by requiring them to adhere to less complex reporting requirements. This would provide regulators with more time and resources to enforce the reporting requirements of larger entities.

### Retraining and Retooling of Accountants and Auditors

The dissemination of a new financial reporting system is a highly complex and lengthy process. Clearly, the level of complexity and the extent to which it is applied has as significant impact on training requirements in the short term and on education requirements in the longer term. In Azerbaijan, for example, little or no education is being provided by any professional organization in IFRS or the national accounting standards.

## Regional Seminar

Following the successful conclusion of the country workshops in Baku, Tbilisi, and Yerevan, a regional seminar was held in Tbilisi on Enhancing Financial Disclosure Standards in Transitional Economies. The seminar's aim was to offer a forum for regulators from the three countries to share their knowledge and experience, and to debate and explore specific issues with international experts. The seminar focused on identifying reform opportunities in financial disclosure standards (financial reporting and auditing, publication of financial statements, compliance with and enforcement of financial disclosure standards, and education and training). Some 21 delegates from various institutions responsible for the development of accounting and auditing standards attended the seminar. The attendees included participants from the country workshops (Appendix 3).

The regional seminar offered a unique opportunity to bring together regulators and accounting and auditing professionals from the three countries to discuss individual and common problems and to identify regional solutions. It was organized around five key themes that were central to the TA project: (i) financial reporting standards; (ii) auditing standards; (iii) publication of financial statements; (iv) monitoring and enforcement; and (v) education, training, and professional bodies.

Each session was led by an invited speaker who opened and introduced the session. Representatives could then present information about the relevant situation in their own countries, identify problems to be addressed, and discuss possible solutions. Five invited speakers from international organizations, including the ACCA, Companies House, the Financial Reporting Council (FRC), the International Accounting Standards Board (IASB), and the World Bank participated in the seminar.[24]

Each of the key areas was led by one of the invited key speakers who made a presentation on best international practice with particular reference to their own country. The presentations were followed by questions and discussion.

The first issue—financial disclosure standards—was addressed by speakers from the IASB and the World Bank. A presentation was made by the marketing director at Companies House on the publication of financial statements by companies in accordance with required standards. In this presentation, the workings of the UK system were contrasted with those of other systems in use in other jurisdictions. The subject of monitoring and enforcement was dealt with by the project manager at the FRC. The presentation highlighted work done by the Professional Oversight Board of the FRC and its role in oversight of audit, accounting, and actuarial matters in the UK, including regulation and monitoring of the UK's professional accounting associations.

The issue of education and training was covered by the head of ACCA Ukraine, Baltic, and Caucasus states together with the IASB representative who also leads the education initiative of the IASC Foundation. The importance of internationally recognized IFRS-based education and training was emphasized in order to be IFAC compliant. The presentation of the World Bank Centre for Financial Reporting and Reform, based in Vienna, provided a full account of the current situation in the Caucasus regarding financial disclosure. The speaker elaborated on the findings of the relevant Reports on the Observance of Standards and Codes (ROSCs) and challenges facing the reform of financial reporting in the region.

The seminar was designed to conclude by firming up the draft country action plans (prepared during the country workshops) in a realistic and attainable manner, benefiting from the synergy generated by participants from the three countries and the experience of the guest speakers. Therefore the final session on the afternoon of day 3 was dedicated to the presentation of the country action plans and discussions on regional initiatives. (See Appendix 6 for the list of seminar participants and speakers.)

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[24] The guest speakers were Andrei Busuioc of the World Bank, Jon Hooper of the FRC, Lynn Lynch of Companies House, Nataliya Vovchuck of the ACCA, and Michael Wells of the IASB (also the co-author of the IASB publication, *IFRS for SMEs*, discussed in Chapter VII).

The regional seminar was instrumental in finalizing the three country action plans and the basis for the countries' coordination in this area after the TA project's conclusion. In its deliberations, ADB summarized and presented to the regional seminar the similarities between the issues faced by the three countries covered by this TA project (see next section). Key issues affecting ongoing reform of financial reporting and disclosure were identified. These were (i) standards gaps, (ii) compliance gaps, (iii) lack of local language translations of IFRS and ISA, (iv) poor awareness of IFAC ethics guidelines, (v) weak control and supervision of the accounting profession, (vi) contradiction between IFRS and national tax accounting requirements, (vii) fragmented corporate disclosure requirements, and (viii) poor corporate governance standards. Potential solutions to these issues were proposed at the regional seminar and are highlighted in Table 7.

**Table 7 Issues Affecting Reform of Financial Disclosure and Potential Solutions**

| Issues | Seminar's Deliberations for Addressing Issues |
|---|---|
| (i) Standards gaps | The regulators and ADB mission members at the regional seminar recognized that their countries' standards often lagged behind IFRS and ISA updates. Mission members recognized that IFRS and ISA standards were written primarily for use in English-speaking common law countries where the doctrine of judicial precedent prevailed. This allowed the adoption of practices not specifically ordained in statute by judicial precedent. The countries follow civil law jurisprudences where judicial precedent is inapplicable as a norm. Frequent amendments to their civil codes are also not possible. Fortunately, Kazakhstan's and Azerbaijan's Civil Code and laws on accounting and auditing have incorporated the principles of the European Union's 8th Directive on Company Law (EU8D).[a] Georgia had drafted similar amendments to its revised civil code and has redrafted accounting and auditing legislation. Regrettably, neither of the drafts was enacted by its legislature. Armenia accepted in principle the logic of applying the EU8D into its statute and advised the seminar that it would assiduously pursue this option in drafting its revised accounting and auditing legislation, also incorporating suggestions from the World Bank's Report on the Observance of Standards and Codes finalized in July 2008 and adopted in March 2009. |
| (ii) Compliance gaps | Mission members and the regulators noted the low level of knowledge of IFRS application and ISA enforcement of public accountants in the three countries. This was further exacerbated by the lack of normative guidelines for practicing accountants and auditors in these areas. Mission members and the regulators agreed that continuous public education for practicing accountants and auditors in the countries was essential to enhance their knowledge of IFRS and the new enforcement of ISA. Translation of IFRS and ISA documents into local languages, coupled with the enactment of enabling legislation for improving corporate governance (see issue viii) and prudential and fiduciary oversight of the profession, could help to improve accountants' and auditors' knowledge of IFRS and ISA. Mission members stated that the drive toward enhancing knowledge should be created internally by the countries' accounting and auditing professions on a self-sustaining basis. The countries endorsed their assessment. |
| (iii) Lack of local language translations of IFRS and ISA standards | Under its TA projects, ADB financed the translation of some IFRS and ISA (necessary for country workshops and regional seminars) into local languages. The countries' regulators appreciated ADB's gesture and recognized that they would have to approach the IASB and IFAC for officially certified translations of IFRS and ISA updates. |
| (iv) Poor awareness of IFAC ethics guidelines | The TA project facilitated the translation into local languages of the IFAC ethics guidelines. Their adoption, however, would require better appreciation by accountants and auditors of their responsibilities, beyond what is (currently) minimally mandated in the countries' laws. Mission members believed that addressing issues (v) to (viii) would help to inculcate in accountants and auditors a sense of ethics. They acknowledged that such a process was likely to evolve gradually. The countries' delegates concurred. |

*continued on next page*

Table 7 *continued*

| Issues | Seminar's Deliberations for Addressing Issues |
|---|---|
| (v) Weak control and supervision of the accounting and auditing profession | Mission members favored the creation of autonomous regulatory boards in the three countries (like the Public Companies Accounting Oversight Board in the United States and the Financial Regulation Council in the United Kingdom [UK]) to supervise the accounting and auditing professions on a fiduciary and prudential basis, answerable to the legislature. Vesting such supervisory powers with the ministry of finance to supervise the accounting and auditing professions on an activist basis could render them over-administered but under-regulated. This could be counterproductive. The country delegates stated that such an evolution would take time given the nascent legal structures, coupled with the absence of the principle of judicial precedent in common law countries. |
| (vi) Contradiction between IFRS and tax accounting requirements | The country workshops organized under the TA project prepared country-specific tax bridges to help accountants reconcile IFRS accounts with tax accounts. The regulators greatly appreciated this intervention. Mission members suggested that where the ministries of finance are the regulators of the accounting and auditing professions, they should discuss within their ministry the enactment of IFRS-compliant tax codes, which would solve both this contradiction and benefit revenue collection, as empirical evidence in Estonia and Poland has demonstrated. Further, as has been proven empirically in Estonia and Poland, an IFRS-friendly tax code reduces corruption through elimination of discretionary and distorting deductions and exemptions. All the countries' ministries of finance accepted this suggestion. |
| (vii) Fragmented corporate disclosure requirements | Mission members suggested the creation of registrars of joint stock companies in the countries, where all relevant financial and operational information about companies would be filed annually on a mandatory basis. Such an institution could become a consolidated public repository of information for all companies incorporated in the country. A format of such information applicable in the UK by Companies House (an incorporated registrar of joint stock companies) was presented to the meetings. The creation of such a register could consolidate information about a company and alleviate the asymmetries and fragmentation in corporate information disclosure and access, a vestige of the Soviet era.[b]<br><br>The countries' regulators noted the generally weak control and supervision over the accounting and auditing professions. |
| (viii) Poor corporate governance standards in the countries (relative to OECD countries) | Mission members suggested the (i) enactment of a Sarbanes-Oxley Act-type of legislation, mandating responsibilities on auditors and corporate managements; (ii) fiduciary oversight over the accounting and auditing professions (see item vii); (iii) creation of public companies' information repositories (see item vi); and (iv) that effective enforcement could enhance corporate governance standards in their countries. The countries' regulators endorsed the suggestion. |

ADB = Asian Development Bank, IFAC = International Federation of Accountants, IFRS = International Financial Reporting Standards, ISA = International Standards on Auditing, OECD = Organisation for Economic Co-operation and Development, TA = technical assistance.

[a] The EU8D has facilitated successfully the incorporation of IFRS and ISA formulated by accountants in common law jurisdictions for civil law countries in the European Union.

[b] During the Soviet era, information was geared toward the needs of the State Statistics Committee, taxation authorities, and enterprises pension obligations to their employees, in that order. Such practices still continue. Information about corporate directors' remuneration and their holdings, as well as the identity of owners is still difficult to discern by a company's stakeholder. In the United Kingdom, Companies House, a state-owned public interest nonprofit company, performs the functions of the registrar of companies under the Companies Act (2005).

Source: Prepared by the author, based on discussions at the regional seminar.

## Comparison of this ADB Technical Assistance Project in the Caucasus with the Previous ADB Technical Assistance Project Covering Central Asia

The previous project undertaken by ADB in the Central Asian republics of Kazakhstan, the Kyrgyz Republic, Mongolia, and Uzbekistan in 2007 and the current project in the South Caucasus are similar in scope and purpose, which is to provide technical assistance to enhance financial disclosure standards in transitional economies. For both projects, country workshops were held in each participating country and these constituted an important feature of the project design. The workshop participants represented a wide range of regulatory bodies—accountants, auditors, professional associations, accounting policy departments of ministries of finance, stock exchanges, tax authorities, financial supervision agencies, and universities. The workshops' content was based on the requirements of stakeholders in the beneficiary countries and those elaborated in the project terms of reference. The range of subjects covered in the current project was, at the specific request of the beneficiaries, more technical and more orientated to IFRS than in the previous project. In both projects good progress was made in enhancing financial disclosure, particularly in Armenia and Georgia where many of the recommendations made by the project regarding the drafting of new accounting laws were incorporated into the country action plans.

Following on from the country workshops, a regional seminar was held for both projects. In each case the aim of the regional seminar was to offer a forum for regulators from the beneficiary countries to share their knowledge and experience and benefit from the presence of international experts. A similar number of delegates from various institutions responsible for the development of accounting and auditing standards in the beneficiary countries attended the seminars. The attendees represented various relevant institutions, including those that participated in the country workshops. A number of resource speakers from organizations including the IASB, the FRC, the ACCA, the World Bank, and Companies House, participated and spoke at the seminar.

In both projects the regional seminars were instrumental in facilitating debate on the common problems and sharing experiences among countries. Again, the seminars were instrumental in encouraging the beneficiary countries to develop and discuss plans articulating priorities and actions for the near future. These plans are important as they provide an insight to the actual problems faced in those countries and they express the priorities of the national governments. This was a valuable outcome of both projects.

Similarities were observed in the stage of reform and the issues faced during the reform process. These included a mix of technical and political issues. The technical issues are affected by political decisions in as much as to be effective they must be incorporated into law. The real political issue is devolution of control, and this is usually encapsulated in the control of the certification of accountants, the licensing of auditors, and the mechanism of enforcement and public disclosure of information.

The previous project identified eight key issues: (i) weak corporate governance standards in the four countries (relative to OECD countries), (ii) weak control and supervision of the accounting and auditing profession, (iii) fragmented corporate information disclosure requirements, (iv) low knowledge by public accountants of IFRS application and ISA enforcement, (v) poor awareness of IFAC ethics guidelines, (vi) contradictions between IFRS and ISA and civil codes (particularly in Kazakhstan and Uzbekistan) and constitutional difficulties in frequently amending them, (vii) contradiction between IFRS standards and the reporting requirements mandated by countries' tax authorities, and (viii) lack of official Russian translations of IFRS and ISA standards.

Despite the difference in location and the fact that over 2 years have passed, the issues identified in the current project in Armenia, Azerbaijan, and Georgia are remarkably similar. The eight key issues identified are (i) the standards gap and a lack of local language translations of IFRS and ISA standards and the ability to keep such translations current and up-to-date, (ii) contradictions between IFRS and tax accounting requirements, (iii) the compliance gap, (iv) poor awareness of IFAC ethics guidelines, (v) fragmented corporate disclosure requirements, (vi) weak control and supervision of the accounting and auditing profession, (vii) poor corporate governance standards in the three countries (relative to OECD countries), and (viii) enforcement gaps.

This is unsurprising as all seven countries are transitioning from a command to a market economy and are also reintegrating into the global economy. The technical issues inherent in the reform of financial reporting will therefore be common to all situations.

There are, however, some possible differences in emphasis rather than of substance. Limited knowledge by public accountants of IFRS application and ISA enforcement was identified as an issue in Central Asia but not in the South Caucasus. In Armenia and Georgia, relative to Central Asia, the knowledge of IFRS and ISA were more widespread notwithstanding the obsolescence of their legislation mandating the standards. In Azerbaijan however, accountants and auditors still need more practical training in applying their domestic, near-IFRS-compliant standards. This appears paradoxical considering the advances in that country's legislation relative to that of its neighbors. Similarly, contradictions between IFRS and ISA and the civil codes (particularly in Kazakhstan and Uzbekistan) and constitutional difficulties in frequently amending them was an issue in Central Asia but not an issue in the Caucasus due to the governments' willing and innovative application of EU8D principles.

Two other attitudinal differences toward accounting and auditing reforms were noticed between Central Asia and South Caucasus. In Central Asia, there was a preference to adopt IFRS and ISA in their entirety, rather than to update their national accounting standards to make them IFRS compatible. In the Caucasus by contrast, there is a preference for step-by-step reform by upgrading existing legislation. This could be attributable to their government's ability and willingness to invoke the principles of EU8D more effectively than in Central Asia.

On the second issue, Russian remains the working language in Central Asia, but this is not so in the Caucasus. Therefore, Central Asian governments and accounting and auditing professional SROs are willing to accept Russian translations of IFRS and ISA documents. The fact that IFAC already has certified Russian language translations of its important documents allows these countries to continue to upgrade their standards even after ADB's TA project ended. By contrast, in the South Caucasus each country insisted on having IFRS and ISA documents translated into its national language, rather than use the already available Russian translation. This would require them to find funding, which could result in a delay in the effective adoption of these standards.

The previous project made four major recommendations regarding the following:

1. **Publication of audited financial statements—**At the regional seminar, the marketing director of Companies House made a presentation on the structure and financing of Companies House and the services it offers. Setting up a similar establishment in one of the four beneficiary countries could provide a valuable model that would benefit other countries in the region.
2. **Implementation of IFRS and ISA—**The four beneficiary countries commenced their transition to IFRS by developing national accounting standards based on IFRS with some making IFRS compulsory for public interest enterprises. Although this approach was instrumental in helping to raise the awareness of standards setters of the processes of standard setting and IFRS, it is fundamentally flawed. IFRS is designed to be applied in its entirety, and creating national versions were justified on the grounds that the standards were not applicable to SMEs and small traders. A second impediment to progress is the lack of availability of official translations of IFRS and ISA in the local languages. Lastly, there is a general lack of capacity within the state institutions responsible for developing and disseminating accounting and auditing standards.
3. **Strengthening regulation and enforcement—**All four beneficiary countries are striving to develop their systems for the regulation and enforcement of financial disclosure standards. Although

considerable effort has been made, there is a serious lack of qualified staff that are adequately trained in IFRS. This makes the task of monitoring compliance with IFRS extremely difficult.

4. **Strengthening education and training and professional bodies—**The education of accountants and auditors in all four beneficiary countries needs to be enhanced. The need for effective education has been stressed by a number of independent studies. Educational establishments are failing to respond to the economy's increasing need for qualified accountants and auditors and few university lecturers possess recognized qualifications in IFRS.

The current project identified a standards gap, a compliance gap, and an enforcement gap to various degrees in all three countries and has assisted in resolving these by providing resources to enable translation of technical documentation as requested by the beneficiaries. The project has also made recommendations to assist in closing the compliance and enforcement gaps, particularly for Armenia and Georgia where there is an opportunity to write these recommendations into the new draft laws.

The current project's conclusions and recommendations are not wholly dissimilar to those of the previous project. As reported in Chapter VIII, they concern supporting Armenia and Georgia in writing their new accounting laws to enable international best practice regarding financial reporting and audit hierarchies, certifying and licensing accountants and auditors, and above all public oversight and compliance enforcement.

A topic outside the TA project's terms of reference (which were drawn up in 2008), but about which several participants in the regional seminar raised questions, was the IASB's 2009 IFRS for SMEs. This subject, which is relevant to transitional economies in Central Asia and the South Caucasus, is the subject of Chapter VII.

# VII. International Accounting Standards Board's International Financial Reporting Standards for Small and Medium-Sized Enterprises

## Background

The majority of enterprises in transitional economies are in the category of micro, small, and medium-sized enterprises (MSMEs), although their definitions vary across jurisdictions. Most MSMEs, because of their small size and limited resources, have not been able to adopt International Financial Reporting Standards (IFRS), and much less so have their financial statements audited according to International Standards on Auditing (ISA). This has resulted in difficulty in accessing debt and equity finance.

ADB's interventions for financing the MSME sector are growing in importance, given this sector's increasing contribution to gross domestic product (GDP) and employment. It is therefore in the interests of ADB and the governments of its developing member countries to help MSMEs improve the quality and transparency of their financial disclosure in accordance with IFRS and ISA. In July 2009, the International Accounting Standards Board (IASB) brought out a new IFRS for small and medium-sized enterprises (SMEs) (footnote 7). This chapter discusses the special standard and its implication for Armenia, Azerbaijan, and Georgia.

## Definitions and Rationale by the International Accounting Standards Board for their Use

The definition of SMEs differs in different countries based on the enterprise's number of employees, turnover, or assets. The IASB's special IFRS defines SMEs taxonomically as entities that do not have public accountability and publish general purpose financial statements for external users (footnote 7). An entity is deemed to have public accountability if (i) its debt or equity instruments are traded in public markets, or are about to be traded; and (ii) if they hold assets in a fiduciary capacity for a broad group of outsiders as their primary (and not incidental) business.[25] General purpose statements have been defined as those directed toward the common information of a wide range of users, e.g., shareholders, creditors, employees, and the public at large. These financial statements comprise the balance sheet, income statement, and cash

[25] Under this definition, a small or medium-sized enterprise, which is a subsidiary of a parent that uses full IFRS, can use this specific IFRS for SMEs, as long as it does not have public accountability.

flow statement, which provide the basic information to their potential investment or credit decision makers. This standard specifically does not require presentation of financial results by segment, earnings per share, or interim financial results of SMEs. That is its principal difference.

The IASB designed this standard so that the financial statements of SMEs could provide adequate information (i.e., information consistent with the disclosure criteria of IFRS) about their financial position, performance, and cash flows that would be useful for economic decision making by a broad range of users. They are a simplified version of full IFRS.

These statements must be clearly presented in a way that is easily understood by users who are assumed to have a reasonable knowledge of business and economic activities and are willing to study this information with due diligence. The information they contain should be relevant, material, reliable, complete, timely, consistent, prudent, and presented with the importance of substance over form in accounting for transactions.

When applied consistently, global financial reporting standards enhance the comparability of financial information. High-quality, comparable financial information based on global reporting standards can improve the pricing and efficiency of allocation of capital. It improves the consistency of audit quality and reduces compliance costs. SMEs, by basing their financial statements on the simplified IFRS principle enunciated in this standard, can benefit from common accounting standards that are comparable internationally. This is beneficial because (i) SMEs globally depend on bank loans, and bankers rely on borrowers' financial statements for credit decisions; (ii) vendors need to evaluate their domestic and foreign buyers' financial health before they sell them goods or services; (iii) credit rating agencies (whose assessment bankers often rely on for making credit decisions) need to develop uniform ratings across companies and across borders, and they in turn need uniform accounting standards for making their assessment; (iv) applying a globalized financial information standard will enable SMEs, particularly those with foreign suppliers, to assess the prospects of viable long-term business relationships, (v) globalized yet simplified IFRS for SMEs can provide venture capital companies with more reliable information about prospective companies under their consideration for potential investment; and (vi) SMEs that follow simplified IFRS for general purpose financial statements become relatively more attractive to outside investors because they follow a globalized financial reporting and disclosure principle. The IASB also recommends the application of this IFRS to microenterprises.

This IFRS was deliberated between 2003 and 2009 in various exposure drafts before the standard was issued in July 2009. The IASB envisages that this standard will be in force until 2012, when it may be revised depending on the feedback received. Thus far, only South Africa has made this standard mandatory for its SMEs.

## Application Considerations

The use of the IASB's IFRS for SMEs would definitely be beneficial to the SMEs of Armenia, Azerbaijan, and Georgia for the following reasons:

**(i) There are a large number of SMEs and their contribution to employment and GDP is considerable.** Recent data show that Armenia has about 123,000 SMEs, comprising approximately 90% of all enterprises in the country, employing about 467,000 persons, and accounting for 41.7% of GDP;[26] Azerbaijan has 74,354 SMEs comprising around 80% of all enterprises,[27] employing 75% of the country's workforce, and accounting for 10% of GDP; and Georgia has 37,711 SMEs, comprising

[26] Armenia. 2008. Ministry of Economy.

[27] ADB Private Sector Loan 7266-AZ: International Bank of Azerbaijan approved by ADB's Board on 5 November 2007.

94.7% of enterprises in the country, and employing 122,434 persons.[28] Given the importance of SMEs as a proportion of total enterprises to the countries' GDPs and employment potential, SMEs constitute an important engine in their economies. Their future growth depends on rational investment decisions, and such decisions need comprehensive financial information. The difficulties of cost and complexity in using the full IFRS means that the release of IFRS for SMEs is a welcome interim step.

(ii) **There is a dependence on bank financing.** Given the lack of depth and maturity of these countries' capital markets, which is exacerbated by information asymmetry, SMEs in the South Caucasus are more dependent on banks for financing than their counterparts in the countries of the Organisation for Economic Co-operation and Development (OECD). Banks in the region need detailed and accurate information about the SMEs to which they lend, particularly after the 2008 global financial turmoil. Using IFRS for SMEs will provide bankers with a more comprehensive and transparent financial overview of the client's financial condition to assist in making rational credit decisions. This is particularly relevant when SMEs in the region seek funding from foreign banks. Financial statements of a globalized standard can help these institutions make rational credit decisions on lending to SMEs in different countries.

(iii) **It would reduce information asymmetry.** If SMEs in a country follow a single yet simplified basis for financial disclosure, such information could more easily be collated and aggregated to facilitate inter-entity comparison. It could also provide a basis for a second tier of companies to display their information on a common electronic registry comparable to Companies House in the United Kingdom. Such public disclosure of information on a globally recognized basis would reduce companies' capital costs while enabling their financiers to allocate capital more rationally.

(iv) **It would facilitate better access to nonbank finance.** Many SMEs in the region depend on credit from their suppliers (of capital goods, raw materials, and spares) from OECD countries. Transparent and comprehensive financial statements that can be understood by suppliers in OECD countries are necessary for SMEs to obtain suppliers' credit at competitive prices. Many SMEs in the region (particularly in agribusiness) also depend on foreign direct investment as an important source of capital funding. This is attributable to the absence of developed, transparent, and liquid stock markets, and the personal or commercial relationships between the locally incorporated company and its foreign (direct) investor. The foreign investor would need comprehensive, transparent, and easily understood financial statements to portray a true and fair condition of the regional investee company. The same analogy also applies to the investment decisions of domestic and foreign venture capital companies considering investment in regional companies. Following the IASB's IFRS for SMEs, these entities will be able to provide globally acceptable financial statements at an affordable cost to their potential financiers and investors.

(v) **SMEs would obtain better access to markets.** Many SMEs in the region export their finished or intermediary products to developed and/or other developing countries. Their importers would need these SMEs' transparent, comprehensible financial statements to determine among other things (i) the SMEs' cost of production and landed cost for claiming any rebates from import duties or value-added taxes charged by revenue authorities at the point of origin or the destination, (ii) the wages paid by an enterprise to its workers to enable importers to comply with laws against labor exploitation in their home countries, and (iii) the suppliers' current ratio and working capital condition to discern the SMEs' ability to cope with peak period orders (particularly, for example, in the case of garments or housewares before the Christmas sales) in all instances, and transparency in financial statements.

[28] Georgia. 2010. National Statistics Office.

(vi) **The tax effects are beneficial.** Tax authorities are important external users of the financial statements of SMEs. Tax authorities have the power to demand any information they need to meet their statutory tax assessment and collection obligations. Tax authorities use audited financial statements as a basis for assessing direct and indirect taxes. Accounting for direct taxes is different from that of IFRS principles. ADB's technical assistance (TA) project designed tax bridges to reconcile income under IFRS and that under direct tax laws. For an enterprise that is subject to direct taxes in more than one jurisdiction, following the IFRS for SMEs can help it determine more clearly and transparently its taxes and refunds due in the two jurisdictions. Conversely, for revenue authorities, an enterprise following the IFRS for SMEs reduces its chances of tax arbitrage.

IFRS for SMEs requires users to account for their indirect taxes on the accrual principle and record them in accordance with the nature of the transaction. This will provide better transparency both to its users and to the revenue authorities in determining more accurately the amount of indirect tax due from or rebate due to the enterprise.

## Issues in Application

The IASB plans to review the standard after 3 years, depending on the feedback from users. There are still some gray areas in interpretation of some sections of this standard. Hence, it may still be considered only experimental. Only South Africa has adopted it so far. However, South Africa is a common law country, with the advantage of judicial precedent for judgments on areas not legislated specifically. South Africa has been following IFRS on a national level since 2001 and IAS before it. The three countries in the South Caucasus do not have the legal and regulatory framework of South Africa to mandate successfully the constitutional adoption of this standard. A possible timetable for its adoption in each country is as follows:

### Armenia

The absence of accounting legislation compliant with the European Union's 8th Directive on Company Law (EU8D) in Armenia could make it more difficult for the country to adopt this standard and amend it after 3 years. The problems of translating the document into Armenian and training accountants, auditors, and tax collectors in the use of the new standard are significant. If funding could be found for translating IFRS into Armenian, the Ministry of Finance (MOF) could offer incentives for SMEs to voluntarily adopt the accounting standard. Simultaneously, the Association of Accountants and Auditors of Armenia (AAAA) will need to train its accountants and auditors in this area. The success of this endeavor is dependent on the MOF ceding more authority to the AAAA, pending the enactment of new and enabling accounting legislation.

### Azerbaijan

Azerbaijan's Law on Accounting (AZLOA) uses the principles of the EU8D, allowing for the easy adoption and integration of IFRS into its statute. Since IFRS for SMEs is provisional, it would be useful for Azerbaijan to consider the adoption of this standard for its SMEs. Azerbaijan can amend its AZLOA after 3 years to incorporate changes that the IASB may make following its review of the standard. AZLOA currently requires all SMEs to follow IFRS. Under the principles of the EU8D, it is legally possible for the MOF by executive order to exempt SMEs from compliance with full IFRS if they comply with simplified IFRS for SMEs. Getting SMEs to comply with this new IFRS will be challenging. To facilitate compliance, the document needs to be translated into Azeri, accountants need to be trained in its use, and auditors need to be trained in applying ISA principles of audit in analyzing documents and transactions prepared under this new standard. Azerbaijan's tax collectors, particularly those working on SMEs, also need to be trained its use. This would require external assistance.

### Georgia

Georgia's draft accounting legislation allows (on the EU8D principle), the adoption and integration of IFRS and ISA upgrades to its legislation. At the time of writing, no government agency regulates the accounting and auditing profession, and there are no reporting rules for SMEs. Pending enactment of the new law, the government could offer SMEs incentives to comply voluntarily with the new IFRS for SMEs. Simultaneously, the Georgian Federation of Professional Accountants and Auditors should translate this IFRS into Georgian and train its members to follow the standard. Inevitably, this will require external funding.

## Conclusion

The adoption of nascent IFRS is potentially beneficial to the SMEs and revenue authorities in the three countries. Directly introducing IFRS for SMEs would obviate the countries' need to update their national standards for SMEs to IFRS compliance. This would release scarce resources for translating standards already developed by the IASB. Given the state of their legal and regulatory frameworks and accounting and auditing conditions, the adoption and enforcement of this new IFRS will require policy dialogue and funding from these countries' development partners. For reform to be meaningful, the countries' governments and their regulators should first be convinced of the benefits that would accrue to them before they seek access to external funding.

# VIII. Conclusion and Recommendations

The importance of accounting and auditing reforms in the context of the wider economic reform programs being undertaken throughout the former Soviet Union is widely recognized. Decision making in a market-oriented economy depends on sound accounting and auditing practices and adequate rules on information disclosure. Fundamental changes in concepts and methods have already been introduced in Armenia, Azerbaijan, and Georgia through the adoption of international standards. The next step is to strengthen institutional arrangements to regulate and enforce those standards.

ADB's technical assistance (TA) project has played an important role in advancing the need for more effective regulation and enforcement to the top of the reform agenda in the three countries. These countries commenced their transition to International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA) in the past decade without empirical knowledge of methodologies for transition. Their experience has provided valuable lessons. ADB's TA project, building on the experience and knowledge gained by ADB under its earlier intervention in Central Asia, added considerable value to this transition. This project trained regulators in the beneficiary countries to better understand the legal and institutional framework necessary to enforce international standards. ADB's training experience in its earlier project[29] was valuable in its design of this TA project. The country workshops provided a forum for in-depth training of regulators and for dealing with country-specific issues, while the regional seminar was instrumental in encouraging debate on the common problems by exploiting synergies and sharing experience across the three countries.

This TA project created considerable awareness of the issues relating to regulation and enforcement of financial disclosure in countries that historically had no tradition of market-oriented accounting and auditing. The depth and quality of the discussions at the regional seminar testifies to the progress that has been made since the early 1990s when the reforms began. There are, however, significant challenges ahead. This section summarizes the key priorities that emerged from the country workshops and the regional seminar for further reform and development of the accounting and auditing infrastructure of the three countries.

Significant changes are underway in accounting, auditing, and disclosure rules and oversight arrangements in the three countries as the authorities seek to bring accounting standards into line with European Union (EU) requirements that, in particular, require all listed companies to prepare their consolidated statements to comply with IFRS.

This TA project has contributed to the three countries' progress in addressing various weaknesses identified in their regulatory frameworks. For the enacted and pending legal and regulatory reforms to be fully effective, it will be essential to significantly strengthen the accounting institutions' capacity to serve as financial standards boards and/or accounting oversight bodies, and to strengthen the professional audit institutions' capacity to act as a self-regulatory organization for their profession.

The thematic priorities to be pursued are as follows:

[29] TA 6249-REG: *Enhancing Financial Disclosure Standards in Transitional Economies* approved in 2005.

## Accounting and Financial Disclosure Standards

It is increasingly apparent that when the accounting reforms began, standards setters in transitional economies lacked sufficient understanding of circumstances surrounding the use of appropriate IFRS, and little guidance was available on this matter. The enterprise sector of the three countries is characterized by the dominance of a small number of economically significant public interest enterprises, mostly in the energy and infrastructure sector, with the remaining vast majority being small and medium-sized enterprises (SMEs). Clearly, the burden of financial reporting on enterprises has to be commensurate with their size, the nature of their ownership, and the need for public accountability. The application of IFRS in its entirety is only of value to the very largest companies, such as public interest enterprises, in which there is considerable national public interest. For example, IFRS are only mandatory in the EU for companies with listed securities and, even in their case, only for consolidated accounts. IFRS are complex and tailored to the specific needs of external investors who require detailed and high-quality information about the financial situation of companies.

For SMEs and companies that do not have external investors, the costs of applying full IFRS may be difficult to justify. This is especially true for nonlisted SMEs, which generally do not have the expertise or resources to implement IFRS. In the three countries, the majority of enterprises do not have outside investors and ownership is vested in the hands of a small number of closely knit shareholders. Adoption of the International Accounting Standards Board's (IASB's) IFRS for SMEs, introduced in 2009, appears to be a step in the right direction.

Armenia needs to rewrite its accounting legislation and empower the Association of Accountants and Auditors of Armenia (AAAA) to certify practicing accountants and auditors. Azerbaijan's new legislation (effective 1 January 2009) is compatible with the European Union's 8th Directive on Company Law. However, it needs to be further refined to facilitate the incorporation of IFRS for SMEs. Georgia needs to enact its draft legislation. It is necessary for all three countries to translate IFRS on a sustainable basis, including future updates. It is recommended that the three countries follow definitive action plans to achieve this.

## Reporting Hierarchy

In their eagerness to adopt IFRS or near IFRS, Armenia and Azerbaijan have mandated all enterprises, including microenterprises and SMEs, to follow near IFRS. Most of them are unable to do so. It is therefore logical (based on disclosure principles in developed countries such as the United Kingdom [UK]) to introduce a reporting hierarchy for different categories of entities. It is recommended that (i) banks and other financial institutions are required to adhere to IFRS; (ii) SMEs are required to follow the IASB's IFRS for SMEs, with microenterprises initially exempted from any standard unless they chose voluntarily to follow IFRS for SMEs; and (iii) other unlisted entities are required to follow IFRS, or near IFRS national standards. This would effectively create four reporting hierarchies. It is necessary for a corporate regulatory authority, such as the Ministry of Finance (MOF), the financial services authority, or the Securities and Exchange Commission, to mandate the reporting requirements for the different types of entities. This corporate regulatory function cannot be delegated to a professional accounting self-regulatory organization (SRO).

## Auditing Standards and Licensing and Certification of Auditors

All three beneficiary countries are striving to develop their systems for regulating and enforcing financial disclosure standards. However, the establishment of regulatory systems is a necessary but insufficient condition to implement effectively IFRS and ISA. The necessary technical infrastructure—education, professional qualifications, and a technical library—must also be in place to enable accountants and auditors to apply international standards in performing their work.

Developing quality audit capacity in the three countries requires their governments to empower their SRO members of the International Federation of Accountants (IFAC) by granting them independence and sustainability. This is a necessary condition to maintain and implement ISA effectively. Azerbaijan's MOF has empowered the Azerbaijan Chamber of Auditors cautiously. The Georgian Federation of Professional Accountants and Auditors has filled the vacuum in Georgia. The MOF's empowerment of the AAAA could help Armenia in this direction. It is recommended that (i) governments delegate the power of certification of auditors to the countries' IFAC member professional accounting SROs, and (ii) governments designate an autonomous state body—comparable to the Financial Reporting Council of the UK or Public Companies Accounting Oversight Board in the United States—to license auditors subject to the conditions that (a) such auditors have been certified only by SROs that are full IFAC members and their certification meets IFAC standards, and (b) the state agency will exercise its licensing power fairly and equitably (i.e., licensing will not be denied without valid justification and the party denied the license shall have the right of appeal against such denial).

## Public Companies Records Registry

It is necessary for the three countries to establish and maintain online registries for the records of their public companies (similar to the role exercised by Companies House [footnote 3]). Such a registry should contain the companies' audited financial statement and audit reports. Information about the companies' directors,' managers,' and employees' remuneration should be posted online. For listed companies and financial institutions, such information should be accessible to any member of the public, including the company's shareholders, employees, creditors, suppliers, and customers. Such a registry will provide important information that the auditors are statutorily required to audit and report on. Any negligence by the auditor can be detected by a vigilant stakeholder through careful review of the information disclosed on the registry. In essence, the creation of such a registry, coupled with the application of IFRS and rigorous enforcement of ISA, is essential for good corporate and financial governance.

The need to make financial statements available to the public was fully debated at the country workshops and international best practices were disseminated to participants. The comprehensive case study, based on Companies House, also served to create greater understanding. At the regional seminar, the marketing director of Companies House presented the history and structure of the organization and the services it offers. Valuable advice was offered on how similar institutions may be established in the three countries and the assistance that Companies House could offer to support such endeavor. Setting up a similar establishment in one of the three countries could provide a valuable model that would benefit other countries in the region. Given that Armenia showed more urgency to address this problem, it may volunteer itself as a suitable pilot country for the creation of an institution similar to Companies House. However, as a point of principle, the availability of financial statements for all public interest enterprises must be a precondition for international assistance in setting up a depository.

## Training and Educating Accountants and Auditors

The education of accountants and auditors in the three beneficiary countries must be enhanced. The need for effective education has been stressed by a number of independent studies. The educational establishments are failing to respond to the economies' increasing need for qualified accountants and auditors. Few university lecturers possess recognized IFRS qualifications.

It is acknowledged that merely having legislation mandating the use of IFRS and ISA without implementing such legislation is ineffective. To ensure adherence to mandated legislation it is essential to train accountants in the use of IFRS and auditors in the use of ISA. This training function is best delegated to the IFAC member professional accounting and auditing SROs. In the context of these three civil law countries, it is necessary to create user guides and notes on implementing IFRS and ISA. Azerbaijan has already done so, and Armenia and Georgia need to do so. Once such guidance notes are issued, it is recommended that they are displayed on the SROs' websites.

# Appendix 1
# Tax Reconciliation Manual

This section presents the tax manual for Uzbekistan as an example.[1] The manual is a step-by-step solution to the case study, which deals with a company in its first 2 years of trading. The tax manual also includes lecture notes, slides, examples, and case studies that were used in the country workshops but are not included here. The entire package was designed to offer comprehensive and quality materials as the basis for designing and delivering a 2-day training course on International Accounting Standards (IAS) 12.

## Background

This manual has been prepared to demonstrate the various differences between profits under the tax code, and profits under International Financial Reporting Standards (IFRS), and to show how these differences should be accounted for. The case study demonstrates how to account for the main differences, using a methodology that is generally applied in practice.

The complexity of the subject is well recognized. Of all the measures to assess whether financial statements have been prepared in accordance with IFRS, it is reasonable to claim that the existence of a deferred tax balance on the balance sheet is the strongest single indicator of IFRS compliance.

The examples and case study solutions together provide examples of all differences between accounts and tax profits that are likely to be found in practice. The comparison should be of general interest to the countries of Central Asia.

## Introduction

Any discussion of how to deal with taxation in financial statements must begin with some consideration of what is to be accounted for. IFRS treats taxation as a business expense to be dealt with in the same manner as any other cost. However, taxation has certain characteristics that set it apart from other costs, which might justify different treatment. These characteristics include the following:

- Tax payments are not made in exchange for any goods or services.
- Businesses have no say in whether or not the payments are to be made.

Due to these factors, certain fiscal economists hold that taxation is more of a distribution than an expense. In essence, the government is a stakeholder in the success of the business and participates in its

[1] A tax reconciliation model was developed under ADB's TA 6249-REG: *Enhancing Financial Disclosure Standards in Transitional Economies* (see 2008 publication of the same title by R. Narasimham and E. Adhami) for Uzbekistan under the earlier TA project and used for demonstration under this TA project. Uzbekistan is a paradigm case study for the differences between IFRS and Tax Accounting.

results. Indeed, due to the nature of tax legislation in most countries, it generally takes priority over other stakeholders.

Treating taxation as a distribution was, in principle, the view adopted under the Soviet accounting system. The validity of this suggestion rather depends on what view is taken as to the purpose of financial statements and the nature of the reporting entity. Now, the accounting practices of countries with transitional economies should lead to convergence with IFRS, in particular with accounting practices consistent with those included in IAS 12—Income Taxes.

Since IFRS takes the view that taxation is a business expense, the most significant accounting issues that arise in relation to taxation are (i) establishing the amount of tax that needs to be paid (the tax expense), and (ii) allocating the tax expense between accounting periods.

The recognition of transactions in the financial statements relating to a particular year is governed primarily by the application of accounting standards. However, the timing of recognition of income and expenses for the purpose of measuring the taxable profit is governed by the application of tax law, which generally follows different rules from those under which the financial statements are drawn up. It is necessary to seek some reconciliation between these different sets of rules, which is where the concept of **deferred tax** is brought into play. The actual tax expense and liability payable for an entity, as calculated under the provisions of the tax code, is referred to by IFRS and throughout this document as **current tax.**

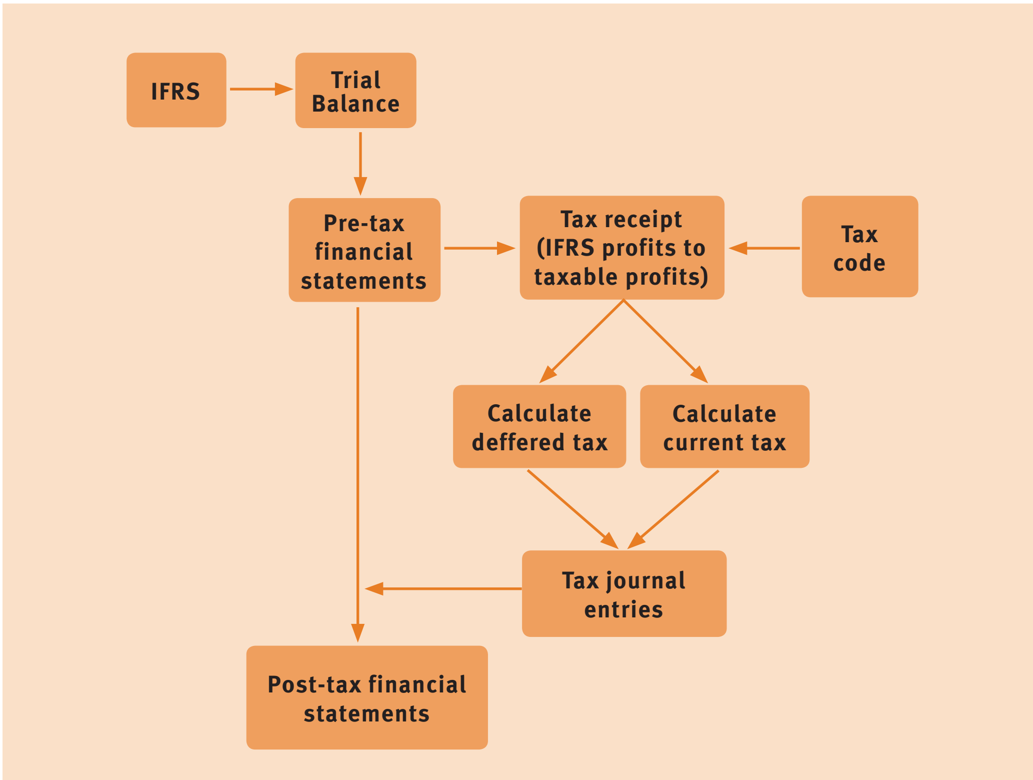
**Deferred taxation**, on the other hand, is the name given to the **accounting methodology** for applying the **accruals concept** to the tax expense and making estimates of the tax expense to be recognized for the current accounting period and those anticipated in future accounting periods. IAS 12 focuses on all differences between the carrying amount of assets and liabilities (the value ascribed to assets and liabilities in the financial statements) and the amount attributed to them for tax purposes (that is, by applying the provisions of the tax code). This approach is known as the **balance sheet liability** method.

IAS 12 deals with four basic areas:

- recognition of the current tax expense (or income) and the associated liability (or asset),
- accounting for current tax,
- recognition of the deferred tax expense (or income) and the associated deferred tax liability (or asset), and
- reconciliation between the tax expense in the financial statements (current tax expense plus deferred tax expense) and the product of the accounting profit multiplied by the applicable rate of tax.

The relationship between taxable profit, accounting profit, current tax, and deferred tax are presented graphically in the figure next page.

**International Financial Reporting Standards: The Tax–Profit Relationship**




IFRS = International Financial Reporting Standards.

Source: R. Narasimham and E. Adhami. 2008. *Enhancing Financial Disclosure Standards in Transitional Economies*. Manila.

## Definitions

### Accounting Profit

Accounting profit is the profit or loss for a period before taxation.

### Taxable Profit

Taxable profit is the figure calculated under the tax code to which the tax percentage is applied to establish the amount of tax that is payable in respect of the reporting period.

### Tax Expense

Tax expense is the aggregate amount included in determining profit for the period. It therefore includes both *current tax and deferred tax* expenses. This is perhaps best understood with reference to the above figure.

The process of establishing the tax expense is as follows:

(i) Calculate the *taxable profits*, by adjusting the accounting profit to take account of the differences between IFRS and the tax code.

(ii) Apply the tax rate to the taxable profits to calculate the *current tax expense.*

(iii) Classify the differences between the taxable profit and the accounting profit as either *permanent differences* or *temporary differences.*

(iv) Compare the carrying value of assets and liabilities with their tax base, and determine the resulting temporary difference at the end of the period.
(v) The income tax rate, as set out in the Tax Code, is applied to the total of the temporary differences to establish the *deferred tax asset or liability*.
(vi) This asset or liability is then compared to the balance for the previous year and the difference, i.e., the movement in the balance, is the *deferred tax expense* or *income*.
(vii) This amount is then added to the *current tax expense* to establish the *tax expense* as shown in the income statement.

## Current Tax

Current tax is the amount of tax actually payable to the tax authorities for the reporting period to which the financial statements relate.

## Temporary Differences

Temporary differences are differences between the carrying amount of an asset or liability in the balance sheet and its tax base. Temporary differences represent items of income or expenditure that are taxable or deductible, but in periods different from those in which they are dealt with in the financial statements. They therefore arise when items of income and expenditure enter into both the measurement of accounting profit and taxable profit but in different accounting periods.

A temporary difference may arise in one of four ways:

(i) Income may be recognized in the financial statements but recognized in taxable profit in later years,
(ii) income may be included in taxable profit in a year earlier than it is recognized in the financial statements,
(iii) expenditure or losses in the financial statements may not be deductible in arriving at the taxable profit until a later period, or
(iv) expenditure or losses may be deducted from taxable profit prior to it being charged against accounting profit.

## Permanent Differences

A permanent difference can arise in three main ways:

(i) Where nontaxable income is included in the accounting profit;
(ii) where certain types of expenditure are charged against accounting profit but are not allowed as expenses against taxable profit; and
(iii) indexation relief, if it were to be granted, might reduce many gains for tax purposes but has no effect on the gains reported in the financial statements.

There is no need to adjust the tax charge in the financial statements for permanent differences. The transactions giving rise to the permanent difference have no future tax effect. Although the tax charge for the year in which the items are reported in the financial statements will deviate from the charge that would be expected if the normal tax rate had been applied to the reported profits (accounting profit), this is not a distortion of the charge that needs to be corrected in any way; indeed any correction or adjustment would itself introduce a distortion. Instead, the impact of permanent differences is disclosed to the users in a note to the financial statements.

### Tax Base

The tax base is critical for establishing the existence and value of temporary differences. To identify temporary differences, an enterprise needs to compare the carrying value of an asset or liability (the accounting value or net book value) with the tax base. In practical terms, this means that for every asset or liability that is treated differently for accounting and tax purposes, the enterprise needs to establish two values for the same asset. Once a mechanism for ascribing two values to the same asset has been established by an enterprise (this is usually achieved by maintaining single-entry subsidiary ledgers such as a fixed asset register), the mechanics of calculating the temporary differences are very straightforward.

### Tax Bases for Assets

The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an enterprise when it recovers the carrying amount (accounting or book value) of the asset. The difference between the carrying amount of an asset and its tax base (the tax authority's value) is described as a temporary difference because it will disappear in time.

As discussed above, these temporary differences arise from the application of different rules, which have the effect of recognizing items of income or expenditure in different reporting periods. Examples of how such differences can arise are set out below.

### Tax Bases for Liabilities

The tax base of a liability is its carrying amount less any amount that will be deductible for tax purposes in respect of that liability in future periods.

### Deferred Tax

Deferred tax is an estimate of the future tax consequences of temporary differences, i.e., it is an estimate of the future tax income or expense resulting from transactions and events recognized in the financial statements in a different period from that in which they are recognized under the tax code.

### Tax Reconciliation Case Study

A theoretical explanation of the differences between financial and taxable profit has been done many times. But theory alone is insufficient for the practical application of this tax reconciliation exercise. Therefore, a case study is presented to assist understanding of the differences between accounting and taxable profit, and to provide practical guidance for tax reconciliation calculations.

## Introduction to the Case Study

**Objectives**

This case study is designed to

- (i) demonstrate the differences between IFRS profits and profits under the tax code,
- (ii) give practice in preparing a reconciliation of IFRS profits to profits under the tax code,
- (iii) give practice in calculating and accounting for deferred tax,
- (iv) demonstrate how to prepare financial statements taking into account deferred taxation issues, and
- (v) demonstrate how to prepare notes to financial statements relating to taxation issues.

**Background**

Cashmere is a new company that manufactures clothes from raw materials purchased from a number of producers and middlemen. Production is carried out in a purpose-built factory a few kilometers out of town, while the administration and selling functions are carried out from a leased office in town.

### Case Study Requirements

Using the Extended Trial Balance, supporting notes, and draft (pretax) financial statements for the first and second years of trading, you are REQUIRED to

(i) prepare a detailed reconciliation of the profits under IFRS with the tax profits,
(ii) calculate the current tax charge in respect of income tax and deferred tax,
(iii) draft the journal entry for the current tax charge,
(iv) prepare financial statements that include deferred tax expense or income and deferred tax liability or asset, and
(v) prepare notes to financial statements relating to current and deferred taxation.

## Case Study—Year 1

### Initial Information for Year 1

During Year 1, Cashmere had the following results:

**Table A1.1 Extended Trial Balance for Year 1** ($)

| | | | | Journal Entries | | | | |
|---|---|---|---|---|---|---|---|---|
| **Item** | **Note** | **Start of Year** | **Cash Book** | **Accruals** | **Depreciation** | **Inventory** | **Others** | **Total** |
| Turnover | 1 | | (150,000) | (50,000) | | | | (200,000) |
| Direct materials | 2 | | 42,000 | 9,000 | | (13,000) | | 38,000 |
| Direct labor | 2 | | 50,000 | | | (13,000) | | 37,000 |
| Machine depreciation | 2 | | | | 40,000 | (10,000) | | 30,000 |
| Factory overheads | 2 | | 35,000 | 7,000 | 16,200 | (14,000) | | 44,200 |
| Administration overheads | 1, 2, 6 | | 14,000 | 1,000 | 5,000 | | 10, 000 | 30,000 |
| Selling overheads | 2 | | 10,000 | 2,000 | 2,500 | | | 14,500 |
| Interest paid | | | 0 | | | | | 0 |
| Interest received | 3 | | (20,000) | | | | | (20,000) |
| Rent received | 4 | | (12,000) | 6,000 | | | | (6,000) |
| Tax charge for year | | | | | | | | 0 |
| Land | | 80,000 | | | | | | 80,000 |
| Factory | 4, 5 | 800,000 | | | | | | 800,000 |
| – accumulated depreciation | 5 | | | | (16,000) | | | (16,000) |
| Canteen | | | 10,000 | | | | | 10,000 |
| – accumulated depreciation | | | | | (200) | | | (200) |

*continued on next page*

Table A1.1 *continued*

| Item | Note | Start of Year | Cash Book | Journal Entries | | | | Total |
|---|---|---|---|---|---|---|---|---|
| | | | | Accruals | Depreciation | Inventory | Others | |
| Machinery | 5 | 400,000 | | | | | | 400,000 |
| – accumulated depreciation | 5 | | | | (40,000) | | | (40,000) |
| Computers | 5 | 10,000 | | | | | | 10,000 |
| – accumulated depreciation | 5 | | | | (5,000) | | | (5,000) |
| Car (sales director) | 5 | 10,000 | | | | | | 10,000 |
| – accumulated depreciation | 5 | | | | (2,500) | | | (2,500) |
| Financial investment | 3 | 100,000 | (10,000) | | | | | 90,000 |
| Bank | | | 31,000 | | | | | 31,000 |
| Trade receivables | 1 | | | 50,000 | | | (10,000) | 40,000 |
| Inventory | 2 | | | | | 50,000 | | 50,000 |
| Bank loan | | 0 | | | | | | 0 |
| Trade payables | 2 | | | (19,000) | | | | (19,000) |
| Deferred income | 4 | | | (6,000) | | | | (6,000) |
| Deferred tax | | | | | | | | 0 |
| Share capital | 7 | (1,400,000) | | | | | | (1,400,000) |
| Retained profits | | | | | | | | 0 |

( ) = negative.

Supporting Notes:

1. Debts are 3 months old, on average. Bad debts of $10,000 were written off to administration overheads, $8,000 of which was approved by the courts.
2. Direct materials are purchased on credit for 2 months. Inventory amounts to 3 months of raw materials and production.
3. At the beginning of the year, a loan of $100,000 was made to a farmer's cooperative to purchase harvesting machinery. This loan bears interest at 20% and is repayable in 10 equal annual installments at the end of each year.
4. Halfway through the year, the company rented out the canteen for $12,000 per year, payable 1 year in advance. It was agreed with the tax authorities that the canteen was a production asset.
5. Fixed assets are depreciated on a straight-line basis, at the following rates:

**Table A1.2 Depreciation of Fixed Assets**

| Type of Fixed Assets | Annual Rate (%) |
|---|---|
| Buildings | 2 |
| Machinery | 10 |
| Computers | 50 |
| Cars | 25 |

6. Administration overheads include:
   - dinner for the Board of Directors of the farmers' cooperative, $3,000; and
   - costs of sending the accountant to study abroad, $5,000.
7. It should be assumed that on the first day of the year, the capital was raised, the assets were purchased, and production was started.

## Solution for Year 1

First, the Income Statement and Balance Sheet for Year 1, using information for the Extended Trial Balance for Year 1, will have to be prepared (Table A1.3).

**Table A1.3 Preliminary Income Statement for Year 1**

| Items of Income Statement | Amount ($) |
|---|---|
| Sales | 200,000 |
| Direct cost of sales | (149,200) |
| **Gross profit** | **50,800** |
| Administration and selling overheads | (44,500) |
| **Net trading profit** | **6,300** |
| Interest received | 20,000 |
| Rent received | 6,000 |
| **Net profit (loss)** | **32,300** |
| Current tax | 0 |
| **Net profit after current tax** | **32,300** |

( ) = negative.

The direct cost of sales represents the total cost of direct materials, direct labor, machine depreciation, and factory overheads for Year 1 (right column in Extended Trial Balance).

Other items of the Income Statement are derived along the same lines as in the Extended Trial Balance.

Current tax is zero. A detailed calculation of current tax will be presented in next subsection under tax reconciliation.

**Table A1.4 Preliminary Balance Sheet for Year 1**

| Assets | Amount ($) |
|---|---|
| Property, plant, and equipment | 1,246,300 |
| Financial assets | 90,000 |
| **Long-term assets** | **1,336,300** |
| Inventory | 50,000 |
| Trade receivables | 40,000 |
| Cash in bank | 31,000 |
| **Current assets** | **121,000** |
| **Total assets** | **1,457,300** |

*continued on next page*

Table A1.4 *continued*

| Assets | Amount ($) |
|---|---|
| **Equity and liabilities** | |
| Share capital | 1,400,000 |
| Retained profit | 32,300 |
| **Total equity** | **1,432,300** |
| Trade payable | 19,000 |
| Deferred income | 6,000 |
| **Total current liability** | **25,000** |
| **Total equity and liability** | **1,457,300** |

Retained profit is entered into the Balance Sheet from the Income Statement.

Other items in the Balance Sheet are directly derived from the appropriate line of the Extended Trial Balance.

### *Reconciliation of Profit*

Next stage is the preparation of profit reconciliation table where the financial profit will be reconciled to the taxable profit.

First of all, we know the amount of financial profit before taxation in accordance with the Income Statement prepared for Year 1 (we may also refer to financial profit as IFRS profit).

IFRS profit: $32,300

The next step is to check for each item of the income and expenses included in Income Statement and determine whether these items are in accordance with the national Tax Code of Uzbekistan.

The first item in which we see the difference is the balance cost of property, plant, and equipment (or, simply, fixed assets). These differences in the balances are due to the different methods used to calculate depreciation and fixed asset disposal.

We know that in IFRS, the company had chosen the *straight line method* of depreciation using the rates according to the Tax Code of Uzbekistan. In accordance with the national Tax Code, fixed assets are depreciated using *reducing balance method*. The depreciation rates as prescribed in the Tax Code are given in Table A1.5.

**Table A1.5 Depreciation Rates Prescribed by the Tax Code**

| Type of Fixed Asset | Annual Rate (%) |
|---|---|
| Buildings | 5 |
| Machinery and equipment | 15 |
| Cars and computers | 20 |

It is important to note that, for tax purposes, cars and computers should be grouped together. Table A1.6 presents the calculation of depreciation for Year 1, both IFRS and for tax purposes.

**Table A1.6 Calculation of Depreciation for Year 1 ($)**

| Assets | Opening Balance | Depreciation | Closing Balance |
|---|---|---|---|
| Total fixed assets—IFRS including: | 1,310,000 | (63,700) | 1,246,300 |
| Land | 80,000 | | 80,000 |
| Buildings | 800,000 | (16,000) | 784,000 |
| Canteen | 10,000 | (200) | 9,800 |
| Machinery | 400,000 | (40,000) | 360,000 |
| Computer | 10,000 | (5,000) | 5,000 |
| Car | 10,000 | (2,500) | 7,500 |
| | | | |
| Total fixed assets—tax base including: | 1,310,000 | (104,500) | 1,205,500 |
| Land | 80,000 | | 80,000 |
| Buildings | 800,000 | (40,000) | 760,000 |
| Canteen | 10,000 | (500) | 9,500 |
| Machinery | 400,000 | (60,000) | 340,000 |
| Computer | 10,000 | (2,000) | 8,000 |
| Car | 10,000 | (2,000) | 8,000 |

( ) = negative, IFRS = International Financial Reporting Standards.

For the first year of Cashmere's operation, opening balances for both calculations are the same. Depreciation for tax purposes will definitely be higher due to higher rates of depreciation. Therefore, IFRS depreciation should be added back to IFRS profit and tax base depreciation should be deducted. This difference is temporary because later, IFRS depreciation will be higher than tax base depreciation and the surplus will be liquidated. The following adjustments to IFRS profit should be made:

*Add back IFRS depreciation: $63,700 (temporary)*
*Deduct tax base depreciation: – $104,500 (temporary)*

From the supporting notes under Table A1.1, we know that $2,000 of bad debts written off was not supported by the court (i.e., it is a subjective decision of the company's management). Therefore, this amount is not deductible by the Tax Code. Consequently, should this amount to be supported by the court or by other events, it could be allowed by the Tax Code. Therefore, this difference is temporary. The following adjustment to IFRS profit should be made:

*Add back the amount of bad debt written off not supported by court: $2,000 (temporary)*

In addition, the cost of the dinner ($3,000) is an allowable business expense but it cannot exceed specific norms established by the Government of Uzbekistan. Under the Tax Code, if turnover does not exceed $34,500, 1% of sales is allowed to be deducted; if sales are between $34,500 and $348,000, 0.2% of sales is allowed to be deducted; and if sales are more than $348,000; 0.05% is allowed to be deducted.

Since the company has $200,000 in revenues,

| | | | |
|---|---|---|---|
| sales up to | $ 34,500 | x 1% | = $345 |
| sales exceeding $34,500 | $ 165,500 | x 0.20% | = $331 |
| | $ 200,000 | | $676 |

A deduction of only **$676** is allowed under the Tax Code, and **$2,324 ($3,000 minus $676)** is not allowed to be deducted. Now we can develop table for reconciliation of IFRS profit to taxable profit (Table A1.7).

**Table A1.7 Reconciliation of International Financial Reporting Standards Profit to Taxable Profit** ($)

| **IFRS profit** | **32,300** | **Status** |
|---|---|---|
| Adjustments: | | |
| Add back depreciation charge | 63,700 | Temporary |
| Capital allowance | (104,500) | Temporary |
| Add back unauthorized bad debt written off | 2,000 | Temporary |
| Add back nondeductible part of dinner cost | 2,324 | Permanent |
| **Taxable profit (loss)** | **(4,176)** | |

( ) = negative, IFRS = International Financial Reporting Standards.

Now we understand why in the preliminary Income Statement (before calculation of deferred taxation), we do not calculate current tax expense: the company has incurred a loss for tax purposes.

### *Calculation of Deferred Tax Asset or Liability*

In accordance with IAS 12, the calculation of deferred taxes should be prepared using the balance sheet liability method. What does it mean? It means that IFRS balance sheet items should be compared with their tax base. There is no reason to calculate permanent differences because they are not allowed in accordance with the Tax Code, and therefore cannot be classified as deferred (see definitions). Table A1.8 shows a calculation of the deferred tax for Year 1 for Cashmere.

**Table A1.8 Deferred Tax Calculation for Year 1** ($)

| **Item** | **IFRS Balance Sheet** | **Tax Base** | **Temporary Differences** |
|---|---|---|---|
| Cash and cash equivalents | 31,000 | 31,000 | 0 |
| Short-term trade receivables | 40,000 | 42,000 | (2,000) |
| Inventories | 50,000 | 50,000 | 0 |
| Long-term financial investments | 90,000 | 90,000 | 0 |
| Property plant and equipment | 1,246,300 | 1,205,500 | 40,800 |
| **Total Assets** | **1,457,300** | **1,418,500** | **38,800** |
| | | | |
| Short-term trade payables | 19,000 | 19,000 | 0 |
| Deferred income | 6,000 | 6,000 | 0 |
| **Total Liabilities** | **25,000** | **25,000** | **0** |

( ) = negative, IFRS = International Financial Reporting Standards.

The total liabilities (excluding equity) and the tax base remain the same as they would have been under IFRS. The tax base of trade receivable increased by the amount of unauthorized bad debt written off. The tax base of fixed assets is derived from the calculation of depreciation and closing balance for tax purposes (see previous subsection).

We see that total assets under the tax base is less than the IFRS total assets by $38,800. This means that $38,800 more has been charged to assets under the tax base than under the IFRS calculation. And this amount will be expensed in accordance with IFRS in later accounting periods. Accordingly, tax that should have been paid in year 1 (when it accrued) was not paid. It will instead be paid in the next accounting year, when the tax expense will be recognized as such in accordance with IFRS principles. However, it will be considered (retrospectively) as an expense of year 1, and will not be considered as an expense in the year in which it was actually paid. This item will therefore be treated as a post-balance sheet event. Therefore, we can conclude that this temporary difference gave rise to deferred tax liability.

Table A1.9 shows how to calculate the amount of Cashmere's deferred tax liability for Year 1.

**Table A1.9 Deferred Tax Liability for Year 1**

| Item | Tax Rate (%) | Amount ($) |
|---|---|---|
| Deferred tax liability | 12 | 4,656.00 |
| Deferred tax (asset) | 12 | 0.00 |
| Loss carry forward | 12 | (501.12) |
| **Net deferred tax liability or asset** | | **4,154.88** |

( ) = negative.

The profit tax rate in accordance with the Tax Code is 12%. Therefore we should calculate the deferred tax liability as 12% of the temporary difference of $38,800 (see previous paragraph). The deferred tax liability is therefore $4,656.

In accordance with the Tax Code, the loss incurred can be carried forward and settled with profits during the next 5 years. The loss incurred in Year 1 in accordance with the tax calculation was $4,176. At a tax rate of 12%, it will be $501.12. Since the loss incurred can be set off against future taxable profits, the deferred tax liability should be reduced by $501.12. Consequently, the net deferred tax liability for Year 1 is $4,154.88.

As this is Cashmere's first year of operation, no deferred tax liability or asset should be brought forward. Thus, the deferred tax liability at the end of Year 1 will be equal to the deferred tax expense for Year 1 (Tables A1.10 and A1.11).

**Table A1.10 Current and Deferred Tax**

| Item | Amount ($) |
|---|---|
| Current tax | 0.00 |
| Deferred tax | 4,154.88 |
| Tax expense | 4,154.88 |

**Table A1.11 Tax According to Income Statement ($)**

| Item | Debit | Credit |
|---|---|---|
| Income statement: profit tax expense | 4,154.88 | |
| Balance sheet: income tax payable | | 0.00 |
| Balance sheet: deferred tax liability | | 4,154.88 |

Now we can complete the IFRS financial statements and include the amount of deferred tax expense into the IFRS Income Statement and the amount of deferred tax liability into the IFRS Balance Sheet (Table A1.12).

**Table A1.12 Completed International Financial Reporting Standards Income Statement for Year 1**

| Income Statement Items | Amount ($) |
|---|---|
| Sales | 200,000.00 |
| Direct cost of sales | (149,200.00) |
| **Gross profit** | **50,800.00** |
| Administration and selling overheads | (44,500.00) |
| **Net trading profit** | **6,300.00** |
| Interest received | 20,000.00 |
| Rent received | 6,000.00 |
| **Net profit (loss)** | **32,300.00** |
| Profit tax expense | (4,154.88.00) |
| **Net profit after current tax** | **28,145.12** |

( ) = negative, IFRS = International Financial Reporting Standards.

Profit tax expense should comprise both current tax expense and deferred tax expense, but in this example it includes only deferred tax expense, as calculated in the previous subsection, because there is no current tax expense. Net profit after taxation therefore reduced the amount of deferred tax expense and is $28,145.12 (Table A1.13). Because the company did not make any appropriations from profit, this amount is transferred to the balance sheet as retained profit.

**Table A1.13 Completed International Financial Reporting Standards Balance Sheet for Year 1**

| Assets | Amount ($) |
|---|---|
| Property, plant, and equipment | 1,246,300 |
| Financial assets | 90,000 |
| **Long-term assets** | **1,336,300** |
| Inventory | 50,000 |
| Trade receivables | 40,000 |
| Cash at bank | 31,000 |
| **Current assets** | **121,000** |
| **Total assets** | **1,457,300** |
| | |
| **Equity and Liabilities** | |
| Share capital | 1,400,000 |
| Retained profit | 28,145 |
| **Total equity** | **1,428,145** |
| Deferred tax liability | 4,155[a] |
| **Total noncurrent liability** | **4,155** |
| Trade payable | 19,000 |
| Deferred income | 6,000 |
| **Total current liability** | **25,000** |
| **Total equity and liability** | **1,457,300** |

[a] This figure has been rounded.

Deferred tax liability calculated in previous paragraph has been included to noncurrent liability (as defined in IAS 12). Accordingly, net profit for Year 1 has been reduced for the amount of deferred tax expense for the year. Because it is the first year of operation for Cashmere, retained profit for the end of Year 1 is equal to net profit after taxation for Year 1.

All other items of the Balance Sheet are the same as on preliminary Balance Sheet, which was prepared earlier.

### *Notes to the Financial Statements Related to Taxation*

An important part of the IFRS financial statements is the notes to the accounts. Each significant item in the Income Statement and Balance Sheet should be disclosed in detail in accordance with the corresponding IAS or IFRS. IAS 12 provides guidance for disclosing information related to current and deferred taxation.

Notes to the financial statements have been prepared for Year 1 relating to taxation items (Table A1.14). Keep in mind that notes prepared for this case study do not cover all possible events that may occur. Notes to the financial statements of your company may have much wider range of information. The purpose of this example is to give an understanding of the importance of providing notes.

**Table A1.14 Income Reconciliation between International Financial Reporting Standards-Based Accounting and the Uzbekistan Tax Code**

| Notes | Amount ($) |
|---|---|
| 1. Major components of tax expense (income) | |
| Current tax (income) or expense | 0.00 |
| Deferred tax expense | 4,154.88 |
| **Tax expense** | **4, 154.88** |
| 2. Explanation of the relationship between tax expense and accounting profit | |
| Accounting profit | 32,300.00 |
| Tax at the applicable tax rate of 12% | 3,876.00 |
| Tax effect of expenses that are not deductible in determining taxable profit: | |
| (Cost of dinner exceeding the allowed limit at 12%, $2,324) | 278.88 |
| **Tax expense** | **4,154.88** |
| The applicable profit tax rate is 12% | |
| 3. Analysis of each type of Temporary Differences | |
| Deferred Tax Liabilities (Assets) | |
| Accelerated depreciation for tax purposes | 4,896.00 |
| Bad debt written off | (240.00) |
| Net loss of the year carried forward | (501.12) |
| **Total** | **4,154.88** |
| Deferred Tax Expense (Income) | |
| Accelerated depreciation for tax purposes | 4,896.00 |
| Bad debt written off | (240.00) |
| Net loss of the year carried forward | (501.12) |
| **Total** | **4,154.88** |

( ) = negative.

**Note 1** discloses the components of profit tax expense shown in the IFRS Income Statement. This note usually comprises the amounts of current tax expense (calculated in accordance with the Tax Code) and deferred tax expense (calculated in accordance with IAS 12). In our example, the current tax is zero, because Cashmere incurred a loss in accordance with the Tax Code. Therefore, the profit tax expense is equal to the deferred tax expense.

**Note 2** discloses the relation between the accounting profit and the profit tax expense shown in the Income Statement. The tax expense is calculated as profit tax rate applicable to IFRS profit adjusted to permanent differences.

**Note 3** comprises (i) disclosure of each component of deferred tax liability at the end of Year 1 (accumulated temporary differences by each type of difference), and (ii) disclosure of each component of deferred tax expense for Year 1 (temporary differences by each type of difference for Year 1).

## Case Study—Year 2

The case study for Year 1 presents the calculation of current tax and deferred tax at the beginning of the company's activity. But in practice, most companies carry on their business for many years. Therefore, it is more important to understand how a company should calculate and present current and deferred taxation in a continuous manner.

### Initial Information for Year 2

#### *Extended Trial Balance*

The Trial Balance and supporting notes for Year 2 provided by Cashmere's accountant are given in Table A1.15.

Supporting notes for Table A1.15:

1. The company bought a new machine at the start of Year 2 to increase production and gross profit margin. Financing came from equity, profits, and a bank loan.
2. Administration overheads in the cashbook include the following items:
   - computer repairs costing $2,500;
   - recovery of bad debts written off in Year 1 of $5,000, including the $2,000 not approved by the court; and
   - tax penalties of $3,500.
3. The sales director's car was sold for $2,000 in the middle of the year.
4. The canteen continues to be rented at $12,000 per year, payable 6 months in advance.
5. The bank loan of $100,000 at 20% was obtained at the start of the year (part finance for new machine). At the end of the year, interest of $10,000 had been paid, but interest of $10,000 was overdue.
6. As in year 1, the farmers' cooperative paid the interest in full and repaid $10,000 of the principle.
7. Included in the inventory is raw material of $4,000 that was purchased in Year 1.

### Solution for Year 2

In general, the logic of the exercise is the same as for Year 1. Therefore, we do not repeat the same actions and will only comment on new items that arose in Year 2.

Table A1.15 Extended Trial Balance for Year 2 ($)

| Item | Note | Start of Year | Opening Accrual | Opening Inventory | Cash Book | Accruals | Depreciation | Inventory | Others | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| Turnover | 1 | | 40,000.00 | | (490,000.00) | (150,000.00) | | | | (600,000.00) |
| Direct materials | | | (9,000.00) | 13,000.00 | 103,000.00 | 26,000.00 | | (33,000.00) | | 100,000.00 |
| Direct labor | | | | 13,000.00 | 120,000.00 | | | (33,000.00) | | 100,000.00 |
| Machine depreciation | 1 | | | 10,000.00 | | | 90,000.00 | (25,000.00) | | 75,000.00 |
| Factory overheads | | | (7,000.00) | 14,000.00 | 88,800.00 | 21,000.00 | 16,200.00 | (33,000.00) | | 100,000.00 |
| Administrative overheads | 2 | | (1,000.00) | | 22,000.00 | 24,000.00 | 5,000.00 | | 20,000.00 | 70,000.00 |
| Selling overheads | | | (2,000.00) | | 21,000.00 | 5,000.00 | 0.00 | | | 24,000.00 |
| Loss on sale of car | 3 | | | | 5,500.00 | | | | | 5,500.00 |
| Interest paid | 5 | | | | 10,000.00 | 10,000.00 | | | | 20,000.00 |
| Interest received | 6 | | | | (20,000.00) | | | | | (20,000.00) |
| Rent received | 4 | | (6,000.00) | | (12,000.00) | 6,000.00 | | | | (12,000.00) |
| Tax charge for year | | | | | | | | | | 0.00 |
| Dividends[a] | | | | | | | | | 50,000.00 | 50,000.00.00 |
| Land | | 80,000.00 | | | | | | | | 80,000.00 |
| Factory[b] | | 810,000.00 | | | | | | | 200,000.00 | 1,010,000.00 |
| – accumulated depreciation | | (16,200.00) | | | | | (16,200.00) | | 32,000.00 | (400.00) |
| Canteen | | 400,000.00 | | | 500,000.00 | | | | | 900,000.00 |
| – accumulated depreciation | | (40,000.00) | | | | | (90,000.00) | | | (130,000.00) |
| Machinery | 1 | 10,000.00 | | | | | | | | 10,000.00 |
| – accumulated depreciation | | (5,000.00) | | | | | (5,000.00) | | | (10,000.00) |
| Computers | | 10,000.00 | | | (10,000.00) | | | | | 0.00 |
| – accumulated depreciation | | (2,500.00) | | | 2,500.00 | | | | | 0.00 |

*continued on next page*

Table A1.15 *continued*

| Item | Note | Start of Year | Opening Accrual | Opening Inventory | Cash Book | Accruals | Depreciation | Inventory | Others | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| Car (sales director) | 3 | 90,000.00 | | | (10,000.00) | | | | | 80,000.00 |
| – accumulated depreciation | 3 | 31,000.00 | | | 69,200.00 | | | | | 100,200.00 |
| Financial investment | 6 | 40,000.00 | (40,000.00) | | | 150,000.00 | | | (7,000.00) | 143,000.00 |
| Bank | | 50,000.00 | | (50,000.00) | | | | 124,000.00 | | 124,000.00 |
| Trade receivables | | 0.00 | | | (100,000.00) | | | | | (100,000.00) |
| Inventory | 7 | | | | | | | | (50,000.00) | (50,000.00) |
| Bank loan | 1, 5 | (19,000.00) | 19,000.00 | | | (86,000.00) | | | (13,000.00) | (99,000.00) |
| Dividends payable | | (6,000.00) | 6,000.00 | | | (6,000.00) | | | | (6,000.00) |
| Trade payables | | (4,154.88) | | | | | | | | (4,154.88) |
| Deferred income | | (1,400,000.00) | | | (300,000.00) | | | | | (1,700,000.00) |
| Deferred tax | | (28,145.12) | | | | | | | | (28,145.12) |
| Share capital | 1 | | | | | | | | (232,000.00) | (232,000.00) |
| Retained profits | | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Revaluation reserve | | | 40,000.00 | | (490,000.00) | (150,000.00) | | | | (600,000.00) |
| | | | (9,000.00) | 13,000.00 | 103,000.00 | 26,000.00 | | (33,000.00) | | 100,000.00 |

( ) = negative.

Journal entries:
[a] The dividend was declared on 25 November.
[b] To revalue the factory to $1,010,000.

### *Preliminary Income Statement*

The preliminary income statement is presented in Table A1.16.

**Table A1.16 Preliminary Income Statement for Year 2**

| Items of Income Statement | Amount ($) |
|---|---|
| Sales | 600,000 |
| Direct cost of sales | (375,000) |
| **Gross profit** | **225,000** |
| Administration overheads | (70,000) |
| Selling overheads | (25,250) |
| Loss on sale of car | (4,250) |
| **Net trading profit** | **125,500** |
| Interest received | 18,000 |
| Rent received | 12,000 |
| Interest paid | (20,000) |
| **Net profit (loss)** | **135,500** |
| Current tax | 0 |
| **Net profit after current tax** | **135,500** |
| Dividends | (50,000) |
| **Undistributed profit** | **85,500** |

( ) = negative.

Explanations of the difference:

(i) The preliminary Income Statement prepared does not take into account deferred tax expense or income.

(ii) Selling overheads includes depreciation of selling director's car for the first 6 months only, because the car was sold in the middle of Year 2.

(iii) Cashmere incurred a loss from the sale of the car (net book value of the car at the middle of Year 2 less cash received from sale).

(iv) The company shows interest expenses comprising $10,000 of interest paid and $10,000 of interest accrued but not yet paid.

(v) The current tax is still zero despite the fact that the company earned a significant amount of profit. But it should be remembered that the company carried forward the loss incurred in Year 1. A detailed calculation of current tax will be presented in the next subsection on tax reconciliation.

(vi) Dividends were declared on 25 November of Year 2, and are therefore included in the Income Statement.

## *Preliminary Balance Statement*

The preliminary balance sheet is presented in Table A1.17.

**Table A1.17 Preliminary Balance Sheet for Year 2**

| **Assets** | **Amount ($)** |
|---|---|
| Property, plant, and equipment | 1,859,600 |
| Financial assets | 80, 000 |
| **Long-term assets** | **1,939,600** |
| Inventory | 124,000 |
| Trade receivables | 143,000 |
| Cash in bank | 98,200 |
| **Current assets** | **365,200** |
| **Total assets** | **2,304,800** |
| | |
| **Equity and Liabilities** | |
| Share capital | 1,700,000 |
| Revaluation reserve | 232,000 |
| Retained profit | 117,800 |
| **Total equity** | **2,049,800** |
| Bank loan | 100,000 |
| **Total noncurrent liability** | **100,000** |
| Dividends payable | 50,000 |
| Trade payable | 99,000 |
| Deferred income | 6,000 |
| **Total current liability** | **155,000** |
| **Total equity and liability** | **2,304,800** |

The preliminary Balance Sheet prepared does not take into account deferred tax liability or assets. Property, plant, and equipment represent the total net book value of all fixed assets listed in the Extended Trial Balance, including the effect of revaluation during Year 2.

The retained profit in the preliminary Balance Sheet is derived from the preliminary Income Statement. Other items in the Balance Sheet are derived from the appropriate lines of the Extended Trial Balance.

## *Reconciliation of Profit*

Again, as for Year 1, we will reconcile financial profit for Year 2 with taxable profit for Year 2.

We already determined the amount of IFRS profit before taxation (and before dividends) in accordance with the preliminary Income Statement prepared for Year 2:

*IFRS profit: $135,500*

The next step is to check each item of the income and expenses, include those in the Income Statement, and determine whether these items are in accordance with the national Tax Code.

As with Year 1, we should determine the amount of IFRS depreciation for Year 2, which should be added back to profit and the amount of capital allowances that should be deducted from profit. The calculations are similar to those of Year 1. It should be remembered that IFRS depreciation is calculated using the straight line method (i.e., the depreciation rate applies to the original cost), and that capital allowance is calculated using the reducing balance method (i.e.,the depreciation rate applies to the balance cost).

Note that the company car and computers are in one group for tax purposes. This is important in calculating the balance cost of the group after the sale of the car in accordance with the Tax Code.

The calculation of depreciation in accordance with the IFRC and Tax Code is shown in Tables A1.18 and A1.19.

**Table A1.18 Carrying Book Value of Assets According to International Financial Reporting Standards**

| Item | Rate Straight Line | Opening Balance | Add or Dispose | Disposal | Revaluation | Closing Balance |
|---|---|---|---|---|---|---|
| **Cost** | **%** | **$** | **$** | **$** | **$** | **$** |
| Factory | 2 | 800,000 | | | 200,000 | 1,000,000 |
| Canteen | 2 | 10,000 | | | | 10,000 |
| Machinery | 10 | 400,000 | 500,000 | | | 900,000 |
| Computers | 50 | 10,000 | | | | 10,000 |
| Car | 25 | 10,000 | | (10,000) | | 0 |
| **Total** | | **1,230,000** | **500,000** | **(10,000)** | **200,000** | **1,920,000** |
| **Depreciation** | | **Opening Balance** | **Charge** | **Disposal** | **Revaluation** | **Closing Balance** |
| Factory | 2 | 16,000 | 16,000 | | (32,000) | 0 |
| Canteen | 2 | 200 | 200 | | | 400 |
| Machinery | 10 | 40,000 | 90,000 | | | 130,000 |
| Computers | 50 | 5,000 | 5,000 | | | 10,000 |
| Car | 25 | 2,500 | 1,250 | (3,750) | | 0 |
| **Total** | | **63,700** | **112,450** | **(3,750)** | **(32,000)** | **140,400** |
| **Carrying value** | | **Opening Balance** | | | | **Closing Balance** |
| Factory | | 784,000 | | | | 1,000,000 |
| Canteen | | 9,800 | | | | 9,600 |
| Machinery | | 360,000 | | | | 770,000 |
| Computers | | 5,000 | | | | 0 |
| Car | | 7,500 | | | | 0 |
| **Total** | | **1,166,300** | | | | **1,779,600** |

( ) = negative, IFRS = International Financial Reporting Standards.

**Table A1.19 Carrying Book Value According to Uzbekistan National Tax Code**

| Item | Rate Straight Line | Relevant Cost Carry Forward | Tax Value Carry Forward | Add or Dispose | Depreciation Allowance | Adjustment | Tax Value Carry Forward |
|---|---|---|---|---|---|---|---|
| | % | $ | $ | $ | $ | $ | $ |
| Factory | 5 | 800,000 | 760,000 | | (40,000) | | 720,000 |
| Canteen | 5 | 10,000 | 9,500 | | (500) | | 9,000 |
| Machinery | 15 | 900,000 | 340,000 | 500,000 | (135,000) | | 705,000 |
| Computers | 20 | 10,000 | 8,000 | | (2,000) | | 6,000 |
| Car | 20 | 0 | 8,000 | (2,000) | (1,000) | (5,000) | 0 |
| **Total** | | **1,720,000** | **1,125,500** | **498,000** | **(178,500)** | **(5,000)** | **1,440,000** |

( ) = negative.

In accordance with the Tax Code, the sale of the car within the prescribed 3-year period does not allow for any deductions; therefore it resulted in a loss of $5,000 arising from the disallowance of depreciation for the previous 2 years hitherto assumed to have been allowable as a deductible expense. These allowances were previously treated as a timing difference, and their loss therefore becomes a permanent difference of $5,000 (two equal and opposite entries could have been made in the tax computation, but we chose to show neither).

Revaluation of fixed assets does not change their balance cost in Uzbekistan's national Tax Code. The effect of this difference will be shown later when the deferred tax liability is determined.

Finally, we calculated depreciation according to IFRS, which adds back to IFRS profit and capital allowances. Capital allowances should be deducted from profit. The following adjustments to IFRS profit should be made:

*Add back IFRS depreciation: $112,450 (temporary)*
*Deduct tax base depreciation: – $178,500 (temporary)*

The car was sold 6 months into Year 2, therefore IFRS depreciation has been calculated for the first 6 months and charged to the cost of production in accordance with IFRS. The original cost of car was $10,000. The accumulated depreciation of $3,750 has been deducted from the total original cost and the total accumulated depreciation at the date of sale. Therefore, the total balance cost has been reduced to $6,250.

The car was sold for $2,000 and its balanced holding value in the books on the date of sale was $6,250. A negative balance amounting to $4,250 has been reflected in the IFRS Income Statement as a loss from the sale of car. This loss can be seen as the result of under-depreciation in the past, and is equivalent to depreciation, and therefore it must be added back. The difference of $4,250 should be added back into profit. The following adjustment to the IFRS profit of Year 2 should be made:

*Add back loss on sale of car: $4,250 (temporary)*

From the supporting notes to Year 1, we know that $2,000 of bad debts written off were not supported by the court, and, therefore, were not allowed by the Tax Code. From the supporting notes to Year 2 we discovered that the company recovered $5,000 of bad debts written off in Year 1, including the $2,000 not approved by the court. Table A1.20 shows the calculation of the balancing difference for Year 2.

**Table A1.20 Calculation of Balancing Difference for Year 2 ($)**

| Item | Accounting | Tax | Difference |
|---|---|---|---|
| Bad debt written off in Year 1 | 10,000 | 8,000 | |
| Recovery of bad debt in Year 2 | (5 ,000) | (3,000) | (2,000) |
| **Balance of bad debt written off** | **5,000** | **5,000** | |

( ) = negative.

At the end of Year 2, both IFRS and taxable profit are deductible for $5,000, which is approved by the court. That is why only $3,000 will be recognized as income of Year 2 for tax purposes. The following adjustment to IFRS profit should be made:

*Deduct from IFRS profit recovery of bad debt not approved by court: –$2,000 (temporary)*

A general provision on doubtful debts has been created by the management at the end of Year 2 because of the uncertainty of receiving cash from debtors due to aging analysis of trade receivables. Provision for legal fees has been made due to expectations that the company will pay those fees after the court's decision. Provision for audit fee is made on the assumption that it is allowed under the Tax Code. All of these provisions have been created due to the accrual basis of accounting. The Tax Code does not allow any provisions made by the company's management. Differences are permanent because these expenses will be recognized in accordance with the Tax Code when they occur in later accounting periods. Therefore, the following provisions made by the company were added back to profit for tax purposes (see supporting notes to Extended Trial Balance for Year 2):

*Add back general provision on doubtful debts: $7,000 (temporary)*
*Add back provision for legal fees: $8,000 (temporary)*

The Tax Code restricts the deduction from taxable income of any penalties and fines charged due to delay of payments of taxes to budget. This difference is permanent. Therefore, the amount of penalty incurred in Year 2 should be added back to profit for tax purposes:

*Add back tax penalty incurred in Year 2: $3,500 (permanent)*

Other incomes and expenses reflected in Cashmere's Income Statement for Year 2 are in accordance with the Tax Code.

Table A1.21 presents the summary table for reconciliation of IFRS profit with taxable profit for Year 2.

**Table A1.21 Summary Table for Reconciliation of International Financial Reporting Standards Profit with Taxable Profit for Year 2**

| Item | Amount ($) | |
|---|---|---|
| **IFRS profit** | **135,500** | |
| Adjustments: | | |
| Add back depreciation charge | 112,450 | (Temporary) |
| Capital allowance | (178,500) | (Temporary) |
| Loss on sale of car | 4,250 | (Temporary) |
| Recovery of bad debt written off | (2,000) | (Temporary) |
| General provision for bad debts | 7,000 | (Temporary) |

*continued on next page*

Table A1.21 *continued*

| Item | Amount ($) | |
|---|---|---|
| Provision for legal fees for Year 2 | 8,000 | (Temporary) |
| Tax penalties | 3,500 | (Permanent) |
| | | |
| **Taxable profit (loss)** | **90,200** | |
| Loss for Year 1 brought forward | (4,176) | |
| **Taxable profit (loss) for Year 2 after deduction** | **86,024** | |

( ) = negative, IFRS = International Financial Reporting Standards.

Now we understand why in the preliminary Income Statement for Year 2 (before calculation of deferred taxation) we do not calculate current tax expense: because the company sets off its profits for the current year against losses incurred in Year 1. In addition, the balance of uncovered loss of Year 1 is carried forward.

### *Calculation of Deferred Tax Asset or Liability*

As with Year 1, the calculation of deferred taxes from Year 2 should be prepared using the balance sheet liability method.

It is important to note that temporary differences in each item of the tax base should be reflected on a cumulative basis. Table A1.22 shows how to calculate the tax base and temporary difference for trade receivable.

**Table A1.22 Calculation of Tax Base and Temporary Difference for Trade Receivable** ($)

| Item | Cost | Accumulated Difference |
|---|---|---|
| Receivable—IFRS balance sheet at the end of Year 2 | 143,000 | |
| Add back bad debt written off in Year 1 (not supported by court) | 2,000 | |
| Deduct recovery of bad debt written off | (2,000) | |
| Add back general provision for doubtful debts | 7,000 | |
| Receivable—Tax Base at the end of Year 2 | 150,000 | (7,000) |

( ) = negative, IFRS = International Financial Reporting Standards.

Tables A1.23 and A1.24 show how to calculate the tax base and temporary difference for property, plant, and equipment (fixed assets). The effect of the revaluation difference will be explained later.

**Table A1.23 International Financial Reporting Standards Base for Calculating the Value of Fixed Assets**

| Item | Rate Straight Line | Opening Balance | Add or Dispose | Disposal | Revaluation | Closing Balance |
|---|---|---|---|---|---|---|
| **Cost** | % | $ | $ | $ | $ | $ |
| Factory | 2 | 800,000 | | | 200,000 | 1,000,000 |
| Canteen | 2 | 10,000 | | | | 10,000 |
| Machinery | 10 | 400,000 | 500,000 | | | 900,000 |
| Computers | 50 | 10,000 | | | | 10,000 |
| Car | 25 | 10,000 | | (10,000) | | 0 |
| **Total** | | **1,230,000** | **500,000** | **(10,000)** | **200,000** | **1,920,000** |
| | | | | | | |
| **Depreciation** | | **Opening Balance** | **Charge** | **Disposal** | **Revaluation** | **Closing Balance** |
| Factory | 2 | 16,000 | 16,000 | | (32,000) | 0 |
| Canteen | 2 | 200 | 200 | | | 400 |
| Machinery | 10 | 40,000 | 90,000 | | | 130,000 |
| Computers | 50 | 5,000 | 5,000 | | | 10,000 |
| Car | 25 | 2,500 | 1,250 | (3,750) | | 0 |
| **Total** | | **63,700** | **112,450** | **(3,750)** | **(32,000)** | **140,400** |
| | | | | | | |
| **Carrying Value** | | **Opening Balance** | | | | **Closing Balance** |
| Factory | | 784,000 | | | | 1,000,000 |
| Canteen | | 9,800 | | | | 9,600 |
| Machinery | | 360,000 | | | | 770,000 |
| Computers | | 5,000 | | | | 0 |
| Car | | 7,500 | | | | 0 |
| **Total** | | **1,166,300** | | | | **1,779,600** |

( ) = negative.

**Table A1.24 Tax Base for Calculating the Value of Fixed Assets**

| Item | Rate Straight Line | Relevant Cost Carry Forward | Tax Value Carry Forward | Add or Dispose | Allowance | Adjustment | Tax Value |
|---|---|---|---|---|---|---|---|
| | % | $ | $ | $ | $ | $ | $ |
| Factory | 5 | 800,000 | 760,000 | | (40,000) | | 720,000 |
| Canteen | 5 | 10,000 | 9,500 | | (500) | | 9,000 |
| Machinery | 15 | 900,000 | 340,000 | 500,000 | (135,000) | | 705,000 |
| Computers | 20 | 10,000 | 8,000 | | (2,000) | | 6,000 |
| Car | 20 | 0 | 8,000 | (2,000) | (1,000) | (5,000) | 0 |
| | | 1,720,000 | 1,125,500 | 498,000 | (178,500) | (5,000) | 1,440,000 |
| | | | | | | | |
| **Temporary Difference (1,179,600–1,440,000)** | | | | | | | **339,600** |

( ) = negative.

The difference between the two financial statements was $8,000, provided for legal fee under the IFRS system. The total amount of provision of $13,000 (comprising $8,000 as legal fee and $5,000 being the difference between the general provision for bad debts of $7,000 and recovery of bad debts worth $2,000, which were written off earlier) will decrease the carrying amount of payables because in accordance with the Tax Code, these expenses are not deductible, and therefore, the tax base of payables should not include the amount of provisions.

Table A1.25 shows the calculation of temporary differences for Year 2.

**Table A1.25 Calculation of Temporary Differences for Year 2 ($)**

| Item | Carrying Amount | Tax Base | Temporary Differences |
|---|---|---|---|
| Cash and cash equivalents | 98,200 | 98,200 | 0 |
| Short-term trade receivables | 143,000 | 150,000 | (7,000) |
| Inventories | 124,000 | 124,000 | 0 |
| Long-term financial investments | 80,000 | 80,000 | 0 |
| Property, plant, and equipment | 1,859,600 | 1,520,000 | 339,600 |
| | | | |
| **Total Assets** | **2,304,800** | **1,972,200** | **332,600** |
| | | | |
| Short-term trade payables | 99,000 | 91,000 | (8,000) |
| Deferred income | 6,000 | 6,000 | 0 |
| Dividends payable | 50,000 | 50,000 | 0 |
| Long-term loan | 100,000 | 100,000 | 0 |
| | | | |
| **Total Liabilities** | **255,000** | **247,000** | **(8,000)** |

( ) = negative.

The items according to tax-based accounting except for equity are similar to those in the IFRS-based balance sheet. The deferred tax liability arises from temporary differences where tax expenses were higher than IFRS expenses, and conversely, the deferred tax asset arises from temporary differences where tax base expenses were less than IFRS expenses (Table A1.26).

**Table A1.26 Summary Calculation of Deferred Tax Liability or Asset**

| Item | Tax Rate (%) | Amount ($) |
|---|---|---|
| Deferred tax liability | 12 | 40,752.00 |
| Deferred tax (asset)—debtors | 12 | (840.00) |
| Deferred tax (asset) | 12 | (960.00) |
| Carry forward of loss of Year 1 on future years | 12 | 0.00 |
| | | |
| Net deferred tax liability (or asset) | | 38,952.00 |
| | | |
| Deferred tax attributable to revaluation surplus | 12 | (27,840.00) |
| | | |
| Net deferred tax liability (or asset) after adjustment on revaluation | | 11,112.00 |
| Deferred tax liability ( or asset) brought forward | | (4,154.88) |
| Movement for the year | | 6,957.12 |

( ) = negative.

The profit tax rate in accordance with the Tax Code is 12%. Therefore, we should calculate the deferred tax liability as 12% of the temporary difference of $332,600 (Table A1.25). The deferred tax liability is therefore $39,912. The deferred tax asset is calculated as 12% of temporary difference of $8,000, amounting to $960. Consequently, the net deferred tax liability for Year 1 is $38,952 (i.e., $39,912 less $960).

Temporary differences also arise in circumstances when assets are revalued and no equivalent adjustment is made for tax purposes. In this case, such a temporary difference should be reflected *directly in equity* and exerts no influence on the tax expense in the Income Statement.

The net deferred tax liability at the end of Year 2 amounted to $38,952, and the deferred tax liability brought forward from Year 1 is $4,154.88 (Table A1.26). Therefore, the deferred tax liability has increased in Year 2. The deferred tax expense for Year 2 (not taking into account a revaluation surplus of $27,840) amounted to $6,957.12.

**Table A1.27 International Financial Reporting Standards-Based and Tax-Based Income Reconciliation**

| Item | Debit | Credit | |
|---|---|---|---|
| Profit tax expense | 17,280.00 | | (Income Statement) |
| Revaluation of assets | 27,840.00 | | (Balance Sheet) |
| Income tax liability | | 10,323.00 | (Balance Sheet) |
| Deferred tax liability | | 34,797.12 | (Balance Sheet) |

Now we can complete the IFRS financial statements and include the amount of deferred tax expense in the IFRS Income Statement and the amount of deferred tax liability in the IFRS Balance Sheet.

**Table A1.28 Completed International Financial Reporting Standards Income Statement for Year 2**

| Items of Income Statement | Amount ($) |
|---|---|
| Sales | 600,000 |
| Direct cost of sales | (375,000) |
| **Gross profit** | **225,000** |
| Administration overheads | (70,000) |
| Selling overheads | (25,250) |
| Loss on sale of car | (4,250) |
| **Net trading profit** | **125,500** |
| Interest received | 18,000 |
| Rent received | 12,000 |
| Interest paid | (20,000) |
| **Net profit (loss)** | **135,500** |
| Profit tax expense | (17,280) |
| **Net profit after current tax** | **118,220** |
| Dividends | (50,000) |
| **Undistributed profit** | **68,220** |

( ) = negative.

The company made appropriations on dividends from profit amounting to $50,000. Therefore, the undistributed profit after appropriation to dividends ($68,220) has been transferred to the balance sheet as retained profit.

**Table A1.29 Completed International Financial Reporting Standards Balance Sheet for Year 2 ($)**

| Assets | Year 1 | Year 2 |
|---|---|---|
| Property, plant, and equipment | 1,246,300 | 1,859,600 |
| Financial assets | 90,000 | 80,000 |
| **Long-term assets** | **1,336,300** | **1,939,600** |
| Inventory | 50,000 | 124,000 |
| Trade receivables | 40,000 | 143,000 |
| Cash in bank | 31,000 | 98,200 |
| **Current assets** | **121,000** | **365,200** |
| **Total assets** | **1,457,300** | **2,304,800** |
| | | |
| **Equity and Liabilities** | | |
| Share capital | 1,400,000 | 1,700,000 |
| Revaluation reserve | 0 | 204,160 |
| Retained profit | 28,145 | 96,365 |
| **Total equity** | **1,428,145** | **2,000,525** |
| Bank loan | 0 | 100,000 |
| Deferred tax liability | 4,155 | 38,952 |
| **Total noncurrent liability** | **4,155** | **138,952** |
| Dividends payable | 0 | 50,000 |
| Trade payable | 19,000 | 99,000 |
| Deferred income | 6,000 | 6,000 |
| Income tax liability | 0 | 10,323 |
| **Total current liability** | **25,000** | **165,323** |
| **Total equity and liability** | **1,457,300** | **2,304,800** |

The deferred tax liability at the end of Year 2, calculated in the previous paragraph, has been included in noncurrent liability (as defined in IAS 12). Accordingly, the net profit for Year 2 has been reduced by the amount of deferred tax expense for Year 2. Therefore, the retained profit at the end of Year 2 has been calculated as the sum of the retained profit at the end of Year 1 ($28,145) and the net profit of Year 2 ($68,220).

In addition, the revaluation of the factory was not matched by any change in the tax base, which is a temporary difference, and resulted in a deferred tax liability. This liability ($232,000 at 12% interest) of $27,840 is debited directly to the revaluation reserve and does not go through the profit and loss account.

All other items in the Balance Sheet are the same as in the preliminary Balance Sheet prepared earlier.

### *Notes to the Financial Statements for Year 2*

An important part of IFRS financial statements is the notes to the accounts. Each of the significant items on the Income Statement and Balance Sheet should be disclosed in detail in accordance with the corresponding IAS or IFRS. IAS 12 provides guidance for disclosure of information related to current and deferred taxation.

Notes relating to taxation items on Cashmere's financial statements have been prepared for Year 2. These notes include comparative data for Year 1. It should be kept in mind that notes prepared in this case study do not cover all possible events that may occur, and notes to the financial statements of your company may have much wider range of information. However, this example gives basis for understanding the principles of note formation.

**Table A1.30 Reconciliation of Income between International Financial Reporting Standards and Uzbekistan Tax System for Years 1 and 2 ($)**

| Notes | Year 1 | Year 2 |
|---|---|---|
| 1. Major components of tax expense (income) | | |
| Current tax (income or) expense | 0.00 | 10,322.88 |
| Deferred tax expense | 3,230.00 | 6,957.12 |
| Tax expense | 3,230.00 | 17,280.00 |
| 2. Aggregate current and deferred tax relating to items charged or credited to equity | | |
| Deferred tax relating to revaluation of property, plant, and equipment | 0.00 | 27,840.00 |
| 3. Explanation of the relationship between tax expense and accounting profit | | |
| Accounting profit | 32,300.00 | 135,500.00 |
| Tax at the applicable tax rate of 12% | 3,876.00 | 16,260.00 |
| Tax effect of expenses that are not deductible in determining taxable profit | | |
| Tax penalties | 0.00 | 420.00 |
| Tax effect of expenses that are not deductive in determining taxable profit | 278.88 | 0.00 |
| **Tax expense** | **4,154.88** | **16,680.00** |
| The applicable profit tax rate is 12% | | |
| 4. Analysis of each type of Temporary Difference | | |
| **Deferred Tax Liabilities (Assets)** | | |
| Accelerated depreciation for tax purposes (including loss on sale of car) | 4,896.00 | 40,752.00 |
| Bad debt written off and provision on bad debt | (240.00) | (840.00) |
| Provisions on legal fee | | (960.00) |
| Net loss of the year carried forward | (501.12) | 0.00 |
| | **4 154.88** | **38,952.00** |
| **Deferred Tax Expense (Income)** | | |
| Accelerated depreciation for tax purposes (including loss on sale of car) | 4,896.00 | 35,856.00 |
| Bad debt written off and provision on bad debt | (240.00) | (600.00) |
| Provisions on legal fee | | (960.00) |
| Revaluation net of related depreciation | | (27,840.00) |
| Net loss of the year carried forward | (501.12) | 501.12 |
| | **4,154.88** | **6,957.12** |

( ) = negative.

**Note 1** discloses the components of profit tax expense shown in the IFRS Income Statement. This Note usually comprises the amount of current tax expense (calculated in accordance with the Tax Code) and deferred tax expense (calculated in accordance with IAS 12).

**Note 2** shows the amount of deferred tax liability, which is related directly to equity accounts (revaluation reserve).

**Note 3** discloses the relation between accounting profit and profit tax expense shown in Income Statement. The tax expense is calculated as profit tax rate applicable to the IFRS profit adjusted to permanent differences.

**Note 4** comprises two parts:

- disclosure of each component of deferred tax liability at the end of Year 2 (accumulated temporary differences by each type of difference), and
- disclosure of each component of deferred tax expense for Year 2 (temporary differences by each type of difference for Year 2).

## Conclusion

Accounting for taxation has long been recognized as a wide-ranging and complicated topic, but it was never an integral part of the Soviet accounting system. Consequently, the practical experience of accountants in dealing with this topic is likely to develop further in the future, and this manual is intended to provide support for that development.

The international accounting standard on taxation (IAS 12) is one of the most fundamental standards, but it is also one of the most difficult standards to apply. It is usually applied in conjunction with other IFRS.

This manual deals with the accounting issues of taxation in the countries covered by ADB's earlier TA project in Central Asia under different tax codes. The results cover almost all the issues that could possibly arise, and it is fair to say that in every country there are unique issues. It is also fair to say that, in general, the tax codes create a high level of difficulty in accounting for taxation. This is not a criticism of the tax codes, but it is a fact.

The detailed complexity generated by the tax codes makes it a challenging task to identify the tax issues, decide whether the issues create permanent or temporary differences, and assess the accounting methodology required. We believe that the explanations in this manual provide sufficient guidance to allow accountants to apply the methodology in any practical situation.

# Appendix 2
# Country Action Plans

## Armenia

| Issue | Actions | Resources | Objectively Verifiable Indicator |
|---|---|---|---|
| 1. Establish suitable relationship model between the Association of Accountants and Auditors of Armenia (AAAA) and the Ministry of Finance of Armenia | The AAAA and Ministry of Finance negotiate the model. Amend laws on accounting and auditing. | Lobby group to assist Parliament in the technical areas of the amendment.<br>Cost of lobbying is nil. | Model is approved, the laws are amended. |
| 2. Introduce a requirement of mandatory membership in a professional body for professional auditors | Amend law on auditing. | Lobby group (technical working party) to assist Parliament in the technical areas of the amendment.<br>Cost of lobbying is nil. | Law amended by Parliament. |
| 3. Quality assurance and management of audits | Amend law on accounting and auditing. | A technically competent and fully funded audit function to<br>• review audits for technical compliance with the audit standards,<br>• review listed entity's financial reports for compliance with the financial reporting standards, and<br>• investigate reported instances of failure to comply with the reporting and audit requirements. | The creation of a self-sustaining review (audit) authority. |
| 4. Introduce additional requirements for certification of professional auditors according to IFAC IES 8. Competence Requirements for Audit Professionals in the AAAA Committee of Education and Certification in order to develop the specific procedure for assessing professional knowledge, skills, values, ethics, and attitudes required of members of the profession who are involved in the audit of financial statements | Develop training programs for existing audit profession, and suitable assessment mechanism. | This activity is very much front-end loaded and external (donor) assistance will be required in the form of technical assistance projects in training and dissemination. | Training programs delivered to training plan. Assessment mechanism established. |

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Armenia *continued*

| Issue | Actions | Resources | Objectively Verifiable Indicator |
|---|---|---|---|
| 5. Establish IFAC-compliant investigation and disciplinary mechanism | Conduct a general review of the system, identify gaps, develop an action plan to fill the gaps, and establish an investigation and discipline function. | Ongoing process of review and improvements of the system. | The sustainable investigation and discipline system established. |
| 6. Agree on financial reporting hierarchy—establish the number of reporting levels and the standards each level will use, and determine which reporting entities will use which levels | Amend law on accounting and auditing. | Lobby group (technical working party) to assist Parliament in the technical areas of the amendment.<br>Cost of lobbying is nil. | Law amended by Parliament. |
| 7. Agree on audit hierarchy for reporting entities | Amend law on accounting and auditing. | Lobby group (technical working party) to assist Parliament in the technical areas of the amendment.<br>Cost of lobbying is nil. | Law amended by Parliament. |
| 8. Sustainable translation of financial and audit standards (to avoid recurrence of a standards gap) | Establish a fully funded self-sustaining translation function. | A self-sustaining ability to translate standards to the IASB and/or IFAC requirements.<br>Ongoing cost not determinable as dependant on the volume of changes each year. | Updated standards available within 6 months of the original standards being issued on an ongoing basis. |
| 9. Dissemination of the new standards (to avoid an applications gap) | Training programs for existing accountants in industry and the audit profession.<br>Change the syllabus used in higher education in line with the new standards and train the trainers. | This activity is very much front-end loaded and external (donor) assistance will be required in the form of technical assistance projects in training and dissemination. | Training programs delivered to training plan.<br>Syllabus modified and training delivered to trainers. |

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Armenia *continued*

| Issue | Actions | Resources | Objectively Verifiable Indicator |
|---|---|---|---|
| 10. Effective compliance and enforcement of the use of appropriate standards (to avoid a compliance gap) | Amend law on accounting and auditing. | Lobby group (technical working party) to assist Parliament in the technical areas of the amendment.<br>Cost of lobbying is nil. Ongoing cost of enforcement to be determined, and will depend on the type and volume of monitoring and the source of the funding. | All reporting entities are either reporting or subject to an effective sanction. |
| 11. Certification of accountants by the AAAA and licensing of auditors by the Ministry of Finance (MOF) | Amend law on accounting and auditing. | Lobby group (technical working party) to assist Parliament in the technical areas of the amendment. Cost of lobbying is nil. | A process for the certification of accountants by the AAAA and licensing of auditors by the MOF established. |
| 12. Improvements in the certification scheme of accountants in order to be fully compliant with IFAC International Education Standards | Review the certification scheme, identify the gaps, and develop an action plan to close the gaps. | This should be done permanently by the AAAA. The partner bodies (ACCA and ICAS) could provide assistance. | The process of permanent review of certification scheme established. |

ACCA = Association of Certified Chartered Accountants, IASB = International Accounting Standards Board, ICAS = Institute of Chartered Accountants of Scotland, IES 8 = International Education Standards 8, IFAC = International Federation of Accountants.

Source: Compiled by the author with the help of the consultant team leader, based on country workshop outputs.

## Azerbaijan

| Issue | Actions | Resources | Objectively Verifiable Indicator |
|---|---|---|---|
| 1. Continuation of arrangements related to the improvement of audit legislation | Prepare draft of additions and amendments to the existing legal acts.<br>Prepare new draft law. | Members and employees of the Chamber, related ministries, and committees<br>Associate foreign audit and accounting bodies<br>Representatives of audit users<br>Representatives of the "Big Four" audit firms[a] | Expectation for acceptance of the laws |
| 2. Improvement of standard base | Translate, edit, and publish commentary and rules about the International Standards on Audit (ISA).<br>Translate, edit, and publish International Education Standards.<br>Constantly translate ISA renewed by the International Federation of Accountants. | Group of translators<br>Group of occupational editors<br>Group of correctors | Translated and improved normative acts |
| 3. Personnel development | Prepare training materials and conduct trainings.<br>Certify auditors. | Working group on preparation of training materials related to personnel training and conducting trainings<br>Associate partners (accredited training partners of foreign audit and accounting bodies and Association of Certified Chartered Accountants) | Existence of professional accounting and audit personnel |
| 4. Strengthening of institutional capacity of Chamber of Auditors | Improve management.<br>Improve structure.<br>Learn and apply the best international practice in this field. | Foreign partners (accounting and auditing bodies of foreign countries)<br>International organizations<br>Existing professional audit and accounting specialists | Improved independent regulatory financial body |

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Azerbaijan *continued*

| Issue | Actions | Resources | Objectively Verifiable Indicator |
|---|---|---|---|
| 5. Provision and control of audit quality | Implement audit quality control system that would respond to international requirements. | Collegial body on quality control<br>Group of professionals supervising the quality of audit | Improved control system |
| 6. Taking measures to replace existing Advisory Council with a constant Board that operates more effectively | Identify Board's financing, budgeting, and work plan using the experience of leading international practice. | State organizations, interested professional parties, and international associates | Creation of professional board which operates more effectively |
| 7. Creation of actively operating public union of accountants (association) that would certify accountants and take care of their professional development | Create initiative group. | All interested parties | Creation of self regulated accounting body |
| 8. Transfer of accounting from previous National Accounting rules into the new National Accounting System | Prepare corresponding instructions. | Related executive bodies and professional bodies | Existence of prepared instructions how to practically move to National Accounting Standards |
| 9. Application of International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) | Prepare corresponding instructions | Organization of practical trainings on application of IAS and IFRS | IAS and IFRS are applied |
| 10. Measures taken to ensure the auditing of obligatory audit objects | Corresponding amendments to civil legislation<br>Audit agitation and popularization<br>Educate economic entities | Members and employees of the Chamber of Auditors<br>Corresponding executive bodies | Decrease in the number and/or elimination of audit evasion circumstances |

[a] Pricewaterhouse Coopers, Ernst & Young, KPMG, and Deloittes Touche Tohmatsu.

Source: Compiled by the author with the help of the consultant team leader, based on country workshop outputs.

## Georgia

| Issue | Actions | Resources | Objectively Verifiable Indicator |
|---|---|---|---|
| 1. Agree financial reporting hierarchy—establish the number of reporting levels and the standards each level will use, and determine which reporting entities will use which levels | Amend law on accounting and auditing. | Lobby group (technical working party) to assist Parliament in the technical areas of the amendment.<br>Cost of lobbying is nil. | Law amended by Parliament |
| 2. Agree audit hierarchy for reporting entities | Amend law on accounting and auditing. | Lobby group (technical working party) to assist Parliament in the technical areas of the amendment.<br>Cost of lobbying is nil. | Law amended by Parliament |
| 3. Sustainable translation of financial and audit standards (to avoid recurrence of standards gap) | Establish a fully funded self-sustaining translation function. | Create self-sustaining ability to translate standards to the requirements of the International Accounting Standards Board and/or the International Federation of Accountants.<br>Ongoing cost is not determinable as it is dependent on the volume of changes each year. | Updated standards available within 6 months of the original standards being issued on an ongoing basis |
| 4. Dissemination of the new standards (to avoid an applications gap) | Establish training programs for existing accountants in industry and the audit profession.<br>Change the syllabus used in higher education in line with the new standards and train the trainers. | This activity is very much front- end loaded and external (donor) assistance will be required in the form of technical assistance projects in training and dissemination. | Training programs delivered according to training plan<br>Syllabus modified and training delivered to trainers |
| 5. Effective compliance and enforcement of the use of the appropriate standards (to avoid a compliance gap) | Amend law on accounting and auditing. | Lobby group (technical working party) to assist Parliament in the technical areas of the amendment.<br>Cost of lobbying is nil. Ongoing cost of enforcement to be determined, and will depend on the type and volume of monitoring and the source of the funding. | All reporting entities either reporting or subject to an effective sanction |
| 6. Certification of accountants and licensing of auditors | Amend law on accounting and auditing. | Lobby group (technical working party) to assist Parliament in the technical areas of the amendment. Cost of lobbying is nil. | A process for the certification of accountants and licensing of auditors established |
| 7. Quality assurance and management of audits | Amend law on accounting and auditing. | A technically competent and fully funded audit function to<br>– review audits for technical compliance with the audit standards<br>– review listed entity's financial reports for compliance with the financial reporting standards<br>– investigate reported instances of failure to comply with the reporting and audit requirements | The creation of a self-sustaining review (audit) authority |

Source: Compiled by the author with the help of the consultant team leader, based on country workshop outputs.

# Appendix 3
# Country-Level Workshop Agendas and Attendees

## Armenia and Georgia Workshop Detailed Agenda

| Module | Time | Minutes | Activity |
|---|---|---|---|
| | | **Day 1** | **Reporting Issues** |
| | 09:00–09:15 | 15 | Registration |
| | 09:16–09:45 | 30 | Introduction |
| 1 | 09:45–10:30 | 45 | Reporting hierarchies and IFRS for SMEs |
| 2 | 10:30–11:15 | 45 | Compliance and enforcement |
| | 11:15–11:30 | 15 | Coffee |
| 3 | 11:30–12:15 | 45 | Second-level reporting |
| 4 | 12:15–13:00 | 45 | Overview of changes to IAS |
| | 13:00–14:00 | 60 | Lunch |
| 4 | 14:00–14:45 | 45 | Overview of changes to IAS |
| 5 | 14:45–15:30 | 45 | IFRS 1 First Time Application |
| | 15:30–15:45 | 15 | Coffee |
| 5 | 15:45–16:30 | 45 | IFRS 1 First Time Application |
| 6 | 16:30–17:15 | 45 | Preparing for audit |
| | | **Day 2** | **Reporting Issues** |
| 6 | 09:00–09:45 | 45 | Preparing for audit |
| 8 | 09:45–10:30 | 45 | IAS 36 Impairment |
| 9 | 10:30–11:15 | 45 | IAS 36 Impairment |
| | 11:15–11:30 | 15 | Coffee |
| 9 | 11:30–12:15 | 45 | IAS 37 Provisions |
| 10 | 12:15–13:00 | 45 | IAS 37 Provisions |
| | 13:00–14:00 | 60 | Lunch |
| 10 | 14:00–14:45 | 45 | IFRS 5 Discontinued operations |
| 10 | 14:45–15:30 | 45 | IFRS 5 Discontinued operations |
| | 15:30–15:45 | 15 | Coffee |
| 11 | 15:45–16:30 | 45 | IAS 12 Taxation |
| 11 | 16:30–17:15 | 45 | IAS 12 Taxation |

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Armenia and Georgia Workshop Detailed Agenda *continued*

| Module | Time | Minutes | Activity |
|---|---|---|---|
| | | **Day 3** | **Reporting Issues** |
| 11 | 09:00–09:45 | 45 | IAS 39 Financial Instruments |
| 12 | 09:45–10:30 | 45 | Concept of fair value |
| 13 | 10:30–11:15 | 45 | Leases and Revaluation of Assets |
| | 11:15–11:30 | 15 | Coffee |
| 14 | 11:30–12:15 | 45 | IAS 7 Cash Flow |
| 15 | 12:15–13:00 | 45 | IAS 38 Intangible Assets |
| | 13:00–14:00 | 60 | Lunch |
| 16 | 14:00–14:45 | 45 | IAS 38 Intangible Assets |
| 16 | 14:45–15:30 | 45 | IAS 40 Investment Property |
| | 15:30–15:45 | 15 | Coffee |
| 17 | 15:45–16:30 | 45 | IAS 8 Accounting Policies |
| 18 | 16:30–17:15 | 45 | IAS 10 Events after the balance sheet date |
| 19 | 17:15–17:30 | 15 | Accounting input into the country action plan |
| | | **Day 4** | **Audit Issues** |
| 23 | 09:00–09:45 | 45 | Audit hierarchies and compliance |
| 24 | 09:45–10:30 | 45 | Recent developments in ISA |
| 25 | 10:30–11:15 | 45 | Professional ethics and education |
| | 11:15–11:30 | 15 | Coffee |
| 26 | 11:30–12:15 | 45 | Quality assurance |
| 27 | 12:15–13:00 | 45 | Management of audits |
| | 13:00–14:00 | 60 | Lunch |
| 28, 29 | 14:00–14:45 | 45 | Audit procedures and documentation |
| 28, 29 | 14:45–15:30 | 45 | Audit procedures and documentation |
| | 15:30–15:45 | 15 | Coffee |
| 28, 29 | 15:45–16:30 | 45 | Audit procedures and documentation |
| | 16:30–17:15 | 45 | Audit input into the country action plan |
| | | **Day 5** | **The Country Plan** |
| 30 | 09:00–09:45 | 45 | Review of generic issues |
| | 09:45–10:30 | 45 | Identify the specific country issues |
| | 10:30–11:15 | 45 | Identify the specific country issues |
| | 11:15–11:30 | 15 | Coffee |
| | 11:30–12:15 | 45 | Identify and agree on the solutions |
| | 12:15–13:00 | 45 | Identify and agree on the solutions |
| | 13:00–14:00 | 60 | Lunch |
| | 14:00–14:45 | 45 | Finalize the draft country action plan |
| | 14:45–15:30 | 45 | Finalize the draft country action plan |
| | 15:30–15:45 | 15 | Coffee |

IAS = International Accounting Standards, IFRS = International Financial Reporting Standards, ISA = International Standards on Auditing, SMEs = small and medium-sized enterprises.

## Azerbaijan Workshop Detailed Agenda

| Module | Time | Minutes | Activity |
|---|---|---|---|
| | | **Day 1 Reporting Issues** | |
| | 09:00–09:15 | 15 | Registration |
| | 09:16–09:45 | 30 | Introduction |
| 1 | 09:45–10:30 | 45 | Reporting hierarchies and IFRS for SMEs |
| 2 | 10:30–11:15 | 45 | Compliance and enforcement |
| | 11:15–1:30 | 15 | Coffee |
| 3 | 11:30–12:15 | 45 | Overview of changes to IAS |
| 4 | 12:15–13:00 | 45 | Overview of changes to IAS |
| | 13:00–14:00 | 60 | Lunch |
| 4 | 14:00–14:45 | 45 | IFRS 1 First Time Application |
| 5 | 14:45–15:30 | 45 | IFRS 1 First Time Application |
| | 15:30–15:45 | 15 | Coffee |
| 5 | 15:45–16:30 | 45 | Preparing for audit |
| 6 | 16:30–17:.15 | 45 | Preparing for audit |
| | | **Day 2 The Country Plan** | |
| 30 | 09:00–09:45 | 45 | Review of generic issues |
| | 09:45–10:30 | 45 | Identify the specific country issues |
| | 10:30–11:15 | 45 | Identify the specific country issues |
| | 11:15–11:30 | 15 | Coffee |
| | 11:30–12:15 | 45 | Identify and agree on the solutions |
| | 12:15–13:00 | 45 | Identify and agree on the solutions |
| | 13:00–14:00 | 60 | Lunch |
| | 14:00–14:45 | 45 | Finalize the draft country action plan |
| | 14:45–15:30 | 45 | Finalize the draft country action plan |
| | 15:30–15:45 | 15 | Coffee |

IAS = International Accounting Standards, IFRS = International Financial Reporting Standards, SMEs = small and medium-sized enterprises.

## Armenia Attendees

| Name | Organization | Name | Organization |
|---|---|---|---|
| Mels Petrosian | Director, AAAA | Tigtan Shahinyan | Profikon CJSC |
| Shusanik Asoyan | Profikon CJSC | Rafik Khacatryan | Profikon CJSC |
| Ashot Barseghyan | Profikon CJSC | Vrej Mkhitaryan | Profikon CJSC |
| Roza Harutyunyan | Xalt LLC | Hermine Markosyan | Fullart LLC |
| Hranush Manukyan | Lata LLC | Karen Fidanyan | FMS Consulting CJSC |
| Kristine Fidanyan | SOS Audit LLC | Nazik Chityan | SOS Audit LLC |
| Gnel Khachatyryan | SOS Audit LLC | Lusine Ghazaryan | SOS Audit LLC |
| Manvel Ghazaryan | SOS Audit LLC | Hrachik Davtyan | SOS Audit LLC |
| Albert Muradyan | SOS Audit LLC | Amalay Hakobyan | Cascade Invest |
| Lilit Shanazaryan | L Four LLC | Agavni Babyan | Perfect Audit LLC |
| Edvard Hambaryan | Kotk Audit LLC | Gayane Apinyan | Kotk Audit LLC |
| Arthur Kerobyan | AVC Consulting and Audit LLC | Arthur Mkhitaryan | AVC Consulting and Audit LLC |
| Margaritta Kalmukhyan | AVC Consulting and Audit LLC | Hasmik Hanesyan | Xartia LLC |
| Elena Ghambaryan | Private Auditor | Levon Ghonyan | Yerevan Audit Council CJSC |
| Naira Xudinyan | Ministry of Finance | Hakob Karapetyan | Ministry of Finance |
| Ruben Zalinyan | Ministry of Finance | Arthur Gomktsyan | Ministry of Finance |
| Satenik Minasyan | Ministry of Finance | Karen Alaverdyan | Ministry of Finance |
| Diana Sargasyan | Ministry of Finance | Armen Melkonyan | Audit Star LLC |
| Guhkas Musheghyan | Audit Star LLC | Anna Aramyan | Molto Bene LLC |
| Marine Tuemanyan | Finco Stat LLC | Simon Abrahamyan | Haypost CJSC |
| Razmik Ohanyan | Haypost CJSC | | |

CJSC = closed joint stock company, LLC = Limited Liability Company.

## Azerbaijan Attendees

| Name | Organization |
|---|---|
| Gasham Bayramov | Chamber of Auditors |
| Hajaf Talibov | Chamber of Auditors |
| Elshan Rahimov | GBRS |

## Georgia Attendees

| Name | Organization |
|---|---|
| Tsotsonava Natia | Financial Supervision Agency |
| Imerlishvili Shota | Financial Supervision Agency |
| Afridonidze Elguja | Audit Council under the Georgian Parliament |
| Chumburidze Lavrenti | Accountant Standards Commission under the Georgian Parliament |
| Dzadzamia Revazi | Institute of Professional Accountants |
| Datiashvili Konstantine | Georgian Federation of Professional Accountants and Auditors |
| Khachidze Maia | BDO–Georgia |
| Zamashvili Givi | BDO–Georgia |
| Chigladze Marekhi | KPMG–Georgia |
| Merkvilishvili Aleksi | KPMG–Georgia |
| Abaiadze Mikheili | UBC International |
| Tsabadze Vakhtangi | UBC International |
| Partskhaladze Temuri | Ltd “Georgian Audit and Consulting Company” |
| Ebanoidze Nodari | Ltd “Kompaudi” |
| Jelia Ivane | Baker Tilly Georgia |
| Kavtievski Aleqsandre | Audit forum |
| Kvatashidze Nadejda | Tbilisi State University |
| Aladashvili Nino | Free University Business School (ESM) |
| Goderdzishvili Ketevan | Insurance Company Imedi |
| Mirotadze Mariami | Audit Firm of Certified Independent Accountants Irma |
| Tsitsilashvili Irakli | Ernst & Young |
| Kejeradze Vaso | Deloitte |
| Pataraia Nino | Ministry of Finance, Methodological Department |

# Appendix 4
# Changes to International Financial Reporting Standards, 2000–2009

## Updates Since 2007

This appendix builds on the similar appendix contained in the previous publication that reported on developments from 2000 to 2007.[1]

In addition to the ongoing changes to International Financial Reporting Standards (IFRS), the International Accounting Standards Board (IASB) issued in October 2009 the long-awaited IFRS for small and medium-sized enterprises (SMEs, which has been 6 years in preparation. This is a significant development as it establishes an IFRS-based second-level reporting structure, which has great relevance to the countries in this project and, indeed, to all transitional economies where the issue of a structured reporting hierarchy has largely gone unaddressed and where the bulk of the economic activity takes place. All the existing standards are included in a document that is less than 10% of the volume of the full IFRS. The overriding principle used to define SMEs is the absence of public accountability. This has allowed a far more easily implemented standard to be created. The main differences are summarized in Table A4.1.

**Table A4.1 Main Differences between Full International Financial Reporting Standards and those for Small and Medium-Sized Enterprises**

| Full IFRS | IFRS for SMEs |
|---|---|
| Standards are numbered as they are published | Organized by topic |
| Almost 3,000 pages | Less than 300 pages |
| About 3,000 disclosure points | About 300 disclosure points |
| Constantly updated | Updated once every 2 or 3 years |

IFRS = International Financial Reporting Standards, SMEs = small and medium-sized enterprises.

Source: Prepared by the author with the help of the consultant team leader.

## Improvements Project 2004

As a result of queries and criticisms about the standards by securities regulators, professional accountants, and others, the IASB redrafted 13 standards in 2004 to reduce or eliminate alternative accounting treatments, redundancies, and conflicts within the standards, and to deal with some convergence issues and make other improvements.

[1] R. Narasimham and E. Adhami. 2008. *Enhancing Financial Disclosure Standards in Transitional Economies*. Manila.

## Financial Instruments (IAS 32, 39, and IFRS 7)

It would be an understatement to say that these standards have generated a lot of discussion. The technical complexity of the subject is in itself an area of some difficulty, as is the drafting of standards to deal with the accounting and disclosure requirements for constantly evolving financial products.

In these discussions, there has been a focus on derivatives, and it is fair to say that derivatives are relatively specialized products in which the majority of accountants have little or no experience. It is equally fair to say, however, that the amounts involved can be significant.

## New Standards

1. IFRS 1, First Time Adoption of IFRS has a self-explanatory title first issued in 2003, last amended in 2008.
2. IFRS 2, Share-Based Payment deals, for the first time, with the recognition and measurement of share-based payments, for example, share options granted to senior executives; first issued in 2004, last amended in 2008.
3. IFRS 3, Business Combinations was first issued in 2003 and last amended in 2008 and replaced IAS 22. IFRS 3 banned pooling and introduced the impairment method for assessing the value of goodwill.
4. IFRS 4, Insurance Contracts was first issued in 2004 and last amended in 2008.
5. IFRS 5, Noncurrent Assets Held for Sale and Discontinued Operations was issued in 2004 and last amended in 2008. It replaced an existing standard for reasons of convergence. IFRS 5 was part of the short-term convergence project with the Financial Accounting Standards Board (FASB), and adopts the classification of assets or "disposal groups" of assets as "held for sale." Such assets are not depreciated, are valued at the lower of carrying value and fair value less costs to sell, and are shown separately on the face of the balance sheet. An operation is now classed as discontinued at the date when the operation meets the criteria to be classified as held for sale.
6. IFRS 6, Exploration for and Evaluation of Mineral Resources was issued in 2004 and last amended in 2008. This standard permits existing industry practices to continue until comprehensive accounting standards are produced for both the insurance industry and the mining, oil, and gas industries.
7. IFRS 7, Financial Instruments: Disclosures was issued in 2005 and last amended in 2008.
8. IFRS 8, Operating Segments was issued in 2006 and last amended in 2007. This is part of the short-term convergence project with the FASB, and requires the disclosure of segmental information on the same classification as that which management uses to manage the business.

## Ongoing Developments

The IASB published an updated work plan in August 2009 covering the issuing of new (or significantly revised) standards on (i) financial instruments, (ii) fair-value accounting, (iii) presentation of financial statements, (iv) leases, (v) revenue, (vi) pensions, and (vii) insurance contracts.

All of these amendments are planned to be completed by the end of 2011. The plan identifies four separate but related issues:

(i) Issues arising from the current financial crisis,
(ii) FASB memorandum of understanding issues,
(iii) conceptual framework issues, and
(iv) other miscellaneous issues.

As part of its planning process, the IASB issued the exposure draft ED 2009 11 Improvements to IFRS, which lists the proposed amendments and changes as:

- **IAS 34 Interim Reporting.** The changes concentrate on the disclosure requirements, in particular to require many of the fair-value discloses as required in IFRS 7 Financial Instruments Disclosures.
- **IAS 40 Investment Property.** Here, the proposal is to remove the requirement to transfer investment property carried at fair value to inventory when it will be developed for sale. Investment property held for sale would be disclosed as a separate category in the balance sheet consistent with the disclosure requirements of IFRS 5 Noncurrent Assets Held for Sale and Discontinued Operations.

In addition, there are other proposed changes covering:[2]

- Accounting policies in the first year of adopting IFRS
- Use of the revaluation basis as the deemed cost for recognition on the first time use of IFRS
- The transition requirements for contingent consideration for business combinations that occurred before the effective date of IFRS 3 Business Combinations of 2008
- The application of IFRS 5 Noncurrent Assets Held for Sale and Discontinued Operations

These changes are discussed in more detail as follows:

## IAS 1—Presentation of Financial Statements

**Major changes:** (i) Extraordinary items are abolished; (ii) the disclosure of judgments of management used in applying accounting policies; (iii) the disclosure of key assumptions concerning the future, and other key sources of estimation uncertainty at the balance sheet date; (iv) minority share of profits (or losses) to be shown as an allocation of profit (or loss), consistent with IAS 27 treating minority interests as equity; (v) in the statement of changes in equity, disclose the total income and expenses for the period (including amounts directly recognized in equity), split between equity holders and minority interests.

**Minor changes:** (i) Clarification of the meaning of "present fairly," and states that IFRS are presumed to achieve a "fair presentation" (in connection with management's opinion that it is necessary to depart from IFRS in financial statements to achieve a "fair presentation"); (ii) the requirements for the selection of accounting policies have been transferred to IAS 8 accounting policies, changes in accounting estimates and errors; (iii) it is no longer a requirement to disclose "the results of operating activities"; (iv) there are minor changes to the classification of a loan as current or noncurrent, in specific circumstances; (v) minor revision to the exemption from reclassifying comparative figures in accordance with current year changes in classification or presentation; and (vi) disclosure of the objectives, policies, and processes for managing capital, and other related information.

The IASB's project to revise this standard is proving to be controversial. Minor changes will come into effect in 2009 but the single biggest change has yet to be agreed. This is the introduction of a single statement of comprehensive income that will include all income statement items and all other comprehensive income items.

## IAS 2—Inventories

**Major change:** The LIFO costing formula is no longer permitted (previously, it was an "allowed alternative" as is common in the US as can be used for tax purposes).

[2] International Accounting Standards Board. 2009. Annual Improvements to IFRSs–Exposure Draft August 2009. London.

**Minor changes:** (i) The requirement to apply the same cost formula for all inventories having a similar nature and use, (ii) the disclosure of the cost of inventories recognized as an expense in the period, and (iii) the disclosure of the carrying amount of inventories carried at fair value less costs to sell.

## IAS 8—Accounting Policies, Changes in Accounting Estimates, and Errors

**Major changes:** (i) Changes in accounting policies, and material prior period errors, must be accounted for retrospectively (previously, the effect of such changes and errors was included in the profit or loss for the current period; now the comparative figures are adjusted); and (ii) the concept of a fundamental error has been eliminated and no longer exists.

**Minor changes:** (i) Financial statements do not comply with IFRS if they contain a material error, (ii) IFRS accounting policies need not be applied if the effect of applying them is immaterial, and (iii) the requirements for the selection of accounting policies have been transferred from IAS 1.

## IAS 10—Events after the Balance Sheet Date

**Major change:** Dividends declared after the balance sheet date are no longer to be recognized as liabilities at the balance sheet date.

## IAS 16—Property, Plant, and Equipment

**Major change:** An asset may be revalued if its fair value can be measured reliably (previously, there was no such condition).

**Minor changes:** (i) Both initial and subsequent costs are now subject to the same general recognition principle (previously, there were two recognition principles); (ii) the costs of dismantlement, removal, and restoration (incurred as a consequence of installing an asset) are now included in the cost of the asset; and (iii) numerous other minor explicit clarifications, which would generally appear predominantly to be common sense, have been made.

## IAS 17—Leases

**Minor changes:** (i) The standard requires the lease of land with an indefinite life to be classified as an operating lease, and clarifies how to account for a lease of both land and buildings. Generally, the land element will be classified as an operating lease, and the building as a finance lease. (ii) In allocating minimum lease payments between land and buildings, there must be an appropriate weighting to take into account the likely depreciation of the building, and the likely lack of depreciation of the land. (iii) Lessors are now required to allocate the initial direct costs of a finance lease (legal fees, commission, etc.) over the lease term (previously, there was an option to treat such costs as an expense).

## IAS 21—The Effects of Changes in Foreign Exchange Rates

**Major changes:** (i) There are two important definitions:

- The "functional currency" is the currency of the primary economic environment in which the entity operates.
- The "presentation currency" is the currency in which the financial statements are presented (and can be any currency).

(ii) The revised standard provides guidance on the determination of the functional currency. (iii) An individual entity must determine its functional currency and measure its results and financial position in that currency. In translating from functional to presentation currency, use closing rates for the balance sheet and average rates for the income statement (as previously in IAS 21 for foreign entities). (iv) Goodwill and fair-value adjustments that arise on acquisition of a foreign entity are to be treated as part of the assets and liabilities of the acquired entity, and hence, translated at the closing rate.

## IAS 23—Borrowing Costs

The standard, revised in 2007 effective 2009, now requires the capitalization of borrowing costs that are directly attributable to the acquisition, construction, or production of a qualifying asset; it is no longer optional.

## IAS 24—Related Party Disclosures

The revised standard provides clarification on a number of issues, more detailed definitions, and more detailed disclosure requirements, including (i) the cost of bad debts with related parties, and (ii) the amounts of transactions with related parties.

## IAS 27—Consolidated and Separate Financial Statements

**Main changes:** (i) Minority interests are to be disclosed separately within equity (i.e., they are no longer to be shown in neither equity nor liabilities); and (ii) in separate financial statements, investments in subsidiaries, jointly controlled entities, and associates will be accounted for at cost or in accordance with IAS 39 (the equity method is no longer permitted).

**Minor changes:** (i) Entities whose debt or equity instruments are traded on a market can never be exempt from consolidation (regardless of any ultimate parent company); (ii) subsidiaries, on which there are restrictions on transferring funds to the parent, can no longer be excluded from consolidation; and (iii) consolidated financial statements must be prepared using uniform accounting policies (previously there was an exemption where it was "not practicable").

## IAS 28—Investments in Associates

**Main change:** Investments held by venture capital organizations, mutual funds, unit trusts, etc., are excluded from the scope of IAS 28 (and IAS 31) if, and only if, the investments are measured at "fair value through profit or loss." If the investment is a subsidiary, however, it should be consolidated in accordance with IAS 27.

**Minor changes:** (i) An associate on which there are restrictions on transferring funds to the investor can no longer be excluded from the equity method of accounting, and (ii) financial statements of associates must be adjusted to conform to the investor's accounting policies (previously, there was an exemption where it was "not practicable").

## IAS 31—Interests in Joint Ventures

**Main change:** Investments held by venture capital organizations, mutual funds, unit trusts, etc., are excluded from the scope of IAS 31 (and IAS 28) if, and only if, the investments are measured at "fair value through profit or loss." If the investment is a subsidiary, however, it should be consolidated in accordance with IAS 27.

**Minor changes:** (i) Exemptions from following the proportionate consolidation or the equity method, similar to those provided for certain parents not required to produce consolidated financial statements (see IAS 27); and (ii) the disclosure method applied to recognize the interest in a jointly controlled entity i.e., proportionate consolidation or the equity method.

## IAS 33—Earnings per Share

The revision merely provided additional guidance and illustrative examples on selected complex issues.

## IAS 40—Investment Property

**Minor changes:** (i) A property interest that is held by a lessee under an operating lease may now be classified and accounted for as investment property, provided that the rest of the definition of investment property is met, and that the fair-value model is used (see IAS 17 on the requirement to classify a lease of land with an indefinite life as an operating lease); and (ii) the choice between the fair-value model and the cost model was retained as more time is required for countries with less well developed property markets and valuation professions to mature.

## IFRS 8—Operating Segments

This standard became effective in 2009 and replaced the previous IAS 14. It focuses on the way that operational information is structured and reported on to the decision makers of the entity. It requires separate reporting by the operating segments of business activities, whose operating and final results are used as inputs by decision makers to assess the segment's performance or its operating and financial efficiency relative to that of the entire entity. This is more in line with the responsibility structure of the business and closely resembles the management accounting of the business. This pattern of constant changes, revisions, and replacements of IFRS is shown in Table A4.2

**Table A4.2 Summary of Changes to International Financial Reporting Standards, 2001–2009**

| | | 2009 | 2008 | 2007 | 2006 | 2005 | 2004 | 2003 | 2002 | 2001 |
|---|---|---|---|---|---|---|---|---|---|---|
| IFRS 1 | First time adoption of IFRS | x | A | A | A | x | N | – | – | – |
| IFRS 2 | Share-based payment | A | A | x | x | x | N | – | – | – |
| IFRS 3 | Business combinations | A | x | x | x | x | N | – | – | – |
| IFRS 4 | Insurance contracts | x | A | x | A | x | N | – | – | – |
| IFRS 5 | Noncurrent assets held for sale and discontinued operations | x | A | x | x | x | N | – | – | – |
| IFRS 6 | Exploration for and evaluation of mineral resources | x | A | x | x | N | – | – | – | – |
| IFRS 7 | Financial instruments: Disclosures | x | A | x | N | – | – | – | – | – |
| IFRS 8 | Operating segments | x | A | N | – | – | – | – | – | – |
| IAS 1 | Presentation of financial statements | A | x | x | A | x | R | x | x | x |
| IAS 2 | Inventories | A | A | x | x | x | R | x | x | x |
| IAS 7 | Cash flow statements | A | A | x | x | x | x | x | x | x |
| IAS 8 | Accounting policies, changes in accounting estimates, and errors | A | A | x | x | x | R | x | x | x |
| IAS 10 | Events after the balance sheet date | A | A | x | x | x | R | x | x | x |
| IAS 11 | Construction contracts | A | A | x | x | x | x | x | x | x |
| IAS 12 | Income taxes | A | A | x | x | x | x | x | x | A |
| IAS 16 | Property, plant, and equipment | A | x | x | x | x | R | x | x | x |
| IAS 17 | Leases | A | x | x | x | x | R | x | x | x |
| IAS 18 | Revenue | A | x | x | x | x | x | x | x | x |
| IAS 19 | Employee benefits | A | x | x | x | A | x | A | x | A |
| IAS 20 | Accounting for government grants and disclosure of government assistance | A | x | x | x | x | x | x | x | x |
| IAS 21 | The effects of changes in foreign exchange rates | A | x | x | A | x | R | x | x | x |
| IAS 23 | Borrowing costs | A | A | x | x | x | x | x | x | x |
| IAS 24 | Related party disclosures | A | x | x | x | x | R | x | x | x |
| IAS 26 | Accounting and reporting by retirement benefit plans | x | x | x | x | x | x | x | x | x |
| IAS 27 | Consolidated and separate financial statements | A | x | x | x | x | R | x | x | x |
| IAS 28 | Investments in associates | A | x | x | x | x | R | x | x | x |
| IAS 29 | Financial reporting in hyper-inflationary economies | A | x | x | x | x | x | x | x | x |
| IAS 31 | Interests in joint ventures | A | x | x | x | x | R | x | x | x |
| IAS 32 | Financial instruments: Presentation | A | A | x | x | x | R | x | x | x |
| IAS 33 | Earnings per share | A | x | x | x | x | R | x | x | x |
| IAS 34 | Interim financial reporting | A | x | x | x | x | x | x | x | x |
| IAS 36 | Impairment of assets | A | x | x | x | x | x | x | x | x |
| IAS 37 | Provisions, contingent liabilities, and contingent assets | A | x | x | x | x | x | x | x | x |
| IAS 38 | Intangible assets | A | x | x | x | x | x | x | x | x |
| IAS 39 | Financial instruments: Recognition and measurement | A | A | x | A | A | R | x | x | A |
| IAS 40 | Investment property | A | x | x | x | x | R | x | x | N |
| IAS 41 | Agriculture | A | x | x | x | x | x | x | x | N |

– = not applicable, A = amended, IAS = International Accounting Standards, IFRS = International Financial Reporting Standards, N = new, R = revisions as a result of International Accounting Standards Board's improvement projects, x = extant.

Source: Prepared by the author and the consultant team leader.

# Appendix 5
# Changes to International Standards on Auditing, 2000–2009

## Overview

### Clarity in Auditing Standards

From 2006 through 2011, the International Auditing and Assurance Standards Board (IAASB) will restructure the auditing standards. For each standard, objectives will be set out, followed by requirements, and then guidance material. Three standards have already been redrafted, and a further 11 redrafted exposure drafts have been published. The earliest date for the introduction of these new standards will be December 2010, to allow time for preparation, and of particular relevance, translation.

In practice, this means that for each year until 2011, there will most probably be major changes and a need to translate each year's edition of the International Standards on Auditing (ISA) to avoid a standards gap opening up.

### Fundamental Changes

Three new risk standards (ISA 315, 330, and 500) were published in 2004 to improve risk assessment and improve the effectiveness of audit procedures designed to respond to risks. These changes are supported by changes in 2005 to both the audit planning standard (ISA 300), and the standard on fraud (ISA 240).

The standard on fraud also expands on the current issues of management fraud and fraudulent financial reporting. Many people, particularly auditors, consider that the bad media coverage attributed to auditors in the wake of recent scandals may more fairly have been directed toward the management and governance procedures of the companies involved.

The 2006 revised standard on audit documentation (ISA 230) introduces a new requirement that audit documentation should enable an "experienced auditor" unconnected with the audit to understand the audit work, evidence, results, significant matters, and conclusions. It is fair to say that the big firms with their own in-house audit approaches have probably complied with this requirement for many years, and it is equally fair to say that some smaller firms may have to revise their documentation standards. The revised standard also introduces some procedural requirements for audit documentation.

Dramatic new changes in 2005 in quality control procedures within audit firms generally (International Standard on Quality Control [ISQC] 1), and for individual audit engagements (ISA 220), introduce aspects of both governance and transparency into the audit process.

Consistent in many ways with the quality control standards, the new 2006 code of ethics introduces five principles: integrity, objectivity, professional competence and due care, confidentiality, and professional behavior.

## Accounting Issues

Three accounting issues were addressed over the period. In 2001, International Auditing Practices Standards (IAPS) 1012 was issued to provide guidance on auditing derivative financial instruments; in 2003, ISA 545 set the standard for auditing fair-value measurements and disclosures; and in 2004, IAPS 1014 dealt with the problems of compliance with IFRS (if all relevant IFRS are not complied with, there is no compliance with IFRS).

# Explanation of Changes to Auditing Standards, 2001–2007

### 2001

#### The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements (ISA 240)

This new standard updates and expands upon previous International Federation of Accountants' International Auditing Practices Committee (IAPC), guidelines and replaces the previous ISA 240. Specifically, the standard emphasizes that when planning and performing an audit procedure, the auditor should consider the risk of material misstatements in the financial statements resulting from fraud and error.

The new standard also

- emphasizes the distinction between management fraud and employee fraud, and expands the discussion of fraudulent financial reporting;
- includes guidance on the need to obtain management's assessment of the risk of fraud; and
- clarifies the discussion of the inherent limitations of an auditor's ability to detect fraud.

During its meeting in March 2001, the IAPC also agreed to move ahead on Phase 2 of the fraud project. This entails the IAPC, working closely with the United States (US) Auditing Standards Board (ASB), to expand upon the existing fraud standard and consider additional basic principles to meet the US Public Oversight Board's recommendations for specific fraud directed procedures in an audit (see 2005 on page 109 for details of further revision).

#### The Auditor's Report on Financial Statements (ISA 700)

This minor revision to ISA 700 requires auditors, in their audit reports, to clearly state the country of origin of the financial reporting framework being used to prepare financial statements (when not IFRS), so that users may better understand the context under which the auditor's opinion is expressed.

Globalization of markets has meant that financial statements are increasingly used by foreign investors and analysts, hence, a clear statement of the particular accounting and auditing frameworks used is essential. This revision merely transforms existing best practice into standard practice.

#### Auditing Derivative Financial Instruments (IAPS 1012)

This new IAPS provides guidance to the auditor in planning and performing auditing procedures for assertions about derivative financial instruments. The focus of the practice statement is on auditing derivatives held by end users, including banks and other financial sector entities when they are the user.

In addition to addressing auditor responsibilities with respect to assertions about derivatives, the new statement also addresses

- responsibility of management and those charged with governance;
- key financial risks;
- risk assessment and internal control, including the role of internal auditing; and
- various types of substantive procedures and when they should be used.

## 2002

No changes.

## 2003

### Auditing Fair-Value Measures and Disclosures (ISA 545)

This new standard considers the increasing number of complex accounting pronouncements containing measurement and disclosure provisions based on fair value. The standard addresses audit considerations relating to the valuation, measurement, presentation, and disclosure of material assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements. Specifically, the standard provides guidance on assessing the appropriateness of fair-value measurements and disclosures, how to design the audit approach, and management's process for determining fair value and management representations. It also discusses when and how the auditor should use the work of an expert on such engagements.

### Electronic Commerce—Effect on the Audit of Financial Statements (IAPS 1013)

This new IAPS has been developed to help auditors address some of the unique risks associated with e-commerce. It identifies specific matters to assist the auditor when considering the significance of internet e-commerce to the entity's business activities, and the effect of internet e-commerce on the auditor's assessments of risk for the purpose of forming an opinion on the financial statements.

> The use of a public network for business-to-consumer, business-to-business, business-to-government, or business-to-employee internet e-commerce presents unique risks to be addressed by an entity and considered by the auditor when planning and performing the audit of financial statements. This is what prompted the IAPC to develop guidance on electronic commerce for auditors. (Jim Sylph, IFAC's technical director.)

The IAPS also outlines the level of skills and knowledge required to understand the effect of internet e-commerce on the audit. It describes the importance of "knowledge of the business," which is fundamental to assessing the significance of e-commerce to the entity's business activity and any effect on audit risk.

Other topics covered include internal control considerations, such as security, transaction integrity, and process alignment; system infrastructure failures; and outsourcing arrangements.

### Others

IAPS 1004 and 1006, both relating to banks, were revised.

## 2004

### Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement (ISA 315); The Auditor's Procedures in Response to Assessed Risk (ISA 330); Audit Evidence (ISA 500)

These three new standards (known collectively as the Audit Risk Standards) are intended to help auditors identify and address audit risks. ISA 310 (Knowledge of the Business) and ISA 400 (Risk Assessments and Internal Control) are withdrawn, and ISA 500 is replaced.

The new standards will increase audit quality as a result of better risk assessments and improved design and performance of audit procedures to respond to risk. Because implementation of the new standards will result in improved linkage of audit procedures and assessed risks, ultimately this should enable auditors to more clearly focus on areas where there is a greater risk of misstatement in the financial statements.

> The proposed standards require auditors to have a deeper understanding of an entity's business environment, to make risk assessments in all audits, and to link the nature, timing and extent of the procedures to the assessed risk. These changes will help to raise standards of audit practice and contribute to building public confidence in audited financial statements. (Dietz Mertin, IAASB chairman.)

### Preface

The IAASB issued a new *Preface to International Standards on Quality Control, Auditing, Assurance and Related Services*, which includes new terms of reference for the Board. It clarifies the IAASB's role as an independent standard-setting body under the auspices of IFAC, highlights its public-interest responsibilities, and emphasizes its objective of achieving convergence of standards by working closely with national standard setters. The previous preface, ISA 100, is withdrawn.

### International Framework for Assurance Engagements; Assurance Engagements Other Than Audits or Reviews of Historical Financial Information (ISAE 3000)

Environmental, social, and sustainability reports; information systems; internal control; corporate governance processes; and compliance with grant conditions, contracts and regulations are some of the subjects about which assurance reports are increasingly being demanded. In recognition of this need, IFAC issued a revised framework, and a new International Standard on Assurance Engagements Other than Audits or Reviews of Historical Financial Information (ISAE) 3000.

The new framework defines and describes the elements and objectives of an assurance engagement, and identifies engagements to which ISA and ISAE apply. It provides a frame of reference for practitioners and others involved with assurance engagements, such as those engaging a practitioner and the intended users of an assurance report. The previous framework, ISA 120, is withdrawn.

ISAE 3000 establishes basic principles and essential procedures for all assurance engagements other than audits or reviews of historical financial information covered by ISA.

### The Special Considerations in the Audit of Small Entities (IAPS 1005)

This revised IAPS takes account of ISA issued from March 1999 to March 2003. It explains how audits of the financial statements of small entities differ from audits of the financial statements of other entities, and was developed with the input of the IFAC Ethics Committee and the Small and Medium Practices (SMP) Task Force. The IAPS is intended to be used by practitioners who already know how to conduct an audit in accordance with ISA.

The IAASB agreed that new international auditing standards issued after March 2003 would, whenever necessary, address SMP considerations directly within the standards themselves. Importantly, the IAPS does not establish any new requirements for the audit of small entities, nor does it establish any exemptions from the requirements of ISA. All audits of small entities are to be conducted in accordance with ISA.

> Ensuring that our standards are relevant to small and medium practices and enterprises is an important IAASB priority. (Dietz Mertin, IAASB chairman.)

### Reporting by Auditors on Compliance with IFRS (IAPS 1014)

Examples have arisen of entities stating that their financial statements have been prepared in accordance with IFRS when, in fact, they have not complied with all the requirements imposed by IFRS. This new practice statement provides guidance on the auditor's responsibilities when management comments on the extent to which financial statements comply with IFRS, when there is not full compliance. It supplements guidance provided in ISA 700, The Auditor's Report on Financial Statements.

## 2005

### Quality Control for Firms that Provide Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements (ISQC 1); Quality Control for Audits of Historical Financial Information (ISA 220)

The first quality control standard, ISQC 1, establishes a **firm's responsibilities** to set up and maintain a system of quality control for all audits and assurance engagements. In addition to setting out guidance on client acceptance and retention criteria that firms should consider, the standard requires that an engagement quality control review must be performed for audits of listed entities and such other engagements as a firm determines.

The review, which must be completed before the audit report can be released, includes consideration of

- significant risks identified during the engagement and the responses to those risks,
- the significance and disposition of corrected and uncorrected misstatements identified during the audit, and
- whether appropriate consultation has taken place on difficult or contentious matters and the conclusions arising from those consultations.

The second quality control standard, ISA 220, establishes standards for the specific responsibilities of firm personnel for an **individual audit engagement** and is consistent with the requirements of the firm-wide quality control standards set out in ISQC 1.

> These new standards, among the most stringent in the world, are necessary in the current environment in order to ensure the highest level of quality in the delivery of assurance services by professional accountants. (John Kellas, IAASB chairman.)

### The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements (ISA 240)

This revised standard builds on the new audit risk standards issued in 2004 and requires the auditor to focus on areas where there is a risk of material misstatement due to fraud, including management fraud. The standard emphasizes the need for the auditor to maintain an attitude of professional skepticism throughout the audit, notwithstanding the auditor's past experience with the honesty and integrity of management and those charged with governance.

The standard requires the engagement team to discuss how the financial statements may be susceptible to material misstatement because of fraud, and what audit procedures would be more effective for their detection. The standard also requires the auditor to design and perform audit procedures to respond to the identified risks of material misstatement because of fraud, including procedures to address the risk of management override of controls.

> While it will always be difficult for the auditor to detect fraud, particularly management fraud, the revised standard provides guidance on considering the risks of fraud in an audit and in designing procedures to detect material misstatements due to fraud, geared at improving auditor performance. (John Kellas, IAASB chairman.)

### Planning an Audit of Financial Statements (ISA 300)

This revised standard builds on the new audit risk standards issued in 2004 and requires the auditor to plan the audit so that the engagement will be performed in an effective manner. The standard emphasizes that planning is a continual process throughout the engagement and that unexpected events, changes in conditions, or other circumstances may lead the auditor to reevaluate the planned audit procedures.

The standard requires the auditor to establish an overall strategy for the audit that sets the scope, timing, and direction of the audit.

> Audit planning plays a critical role in setting the tone and direction of the audit, and in ensuring that the right resources are allocated to the higher risk areas at the appropriate time. The establishment of the overall audit strategy helps guide the development of the more detailed audit plan and ensures that risk assessment procedures and further detailed audit procedures are appropriately targeted. (John Kellas, IAASB chairman.)

### The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements (ISA 700)

This revised standard, effective only for audit reports dated on or after 31 December 2006, deals with separate audit reporting requirements in connection with (i) an ISA audit, and (ii) supplementary reporting responsibilities required in some jurisdictions. Essentially, the standard requires a two-part report: first the audit report on the financial statements under ISA (standard wording), and then any local regulatory requirements.

The revised standard also updates and strengthens the requirements of the standard. In particular, new guidance is given on the auditor's consideration of whether an accounting framework is acceptable, and on the need for the auditor to consider whether the financial statements are misleading even when they comply in all respects with that framework. The new wording for the auditor's report includes

- better explanations of the respective responsibilities of management and the auditor,
- an updated description of the audit process to reflect the new IAASB Audit Risk Standards, and
- clarification of the scope of the auditor's responsibilities with respect to internal control.

### Modifications to the Independent Auditor's Report (ISA 701)

This "new" standard provides guidance on reports that are not unqualified. It is the same guidance as in the old ISA 700, amended for the changes in wording of the audit report under the revised ISA 700.

### Code of Ethics for Professional Accountants

The revised code of ethics provides a conceptual framework for all professional accountants to ensure compliance with the five fundamental principles of professional ethics as follows:

(i) Integrity
(ii) Objectivity

(iii) Professional competence and due care
(iv) Confidentiality
(v) Professional behavior

Under the framework, all professional accountants are required to identify threats to these fundamental principles, and, if there are threats, apply safeguards to ensure that the principles are not compromised.

A member body of IFAC or firm may not apply less stringent standards than those stated in the code.

## 2006

### Audit Documentation (ISA 230)

This revised standard on the important topic of audit documentation strengthens the requirements in five areas:

- It places a new emphasis on the timely preparation of audit documentation necessary to provide a sufficient and appropriate record of the basis for the auditor's report, and evidence that the audit was carried out in accordance with ISA and applicable legal and regulatory requirements.
- It establishes a new requirement that the auditor prepares the audit documentation so as to enable an **experienced auditor**, having no previous connection with the audit, to understand the audit work performed, the results and audit evidence obtained, and the significant matters identified and conclusions reached thereon. It also defines the meaning of an "experienced auditor." (The previous ISA only suggested that the auditor may find it useful to consider what would be necessary to provide another auditor, having no previous experience with the audit, with an understanding of the work performed and the basis for the main decisions taken.)
- It establishes a new requirement that if the auditor judges it necessary to depart from relevant ISA requirements because of exceptional circumstances, the auditor must document how the alternative audit procedures performed meet the objective of the audit and, if not otherwise clear, the reasons for the departure.
- It establishes a new requirement that the auditor completes the assembly of the final audit file on a timely basis after the date of the auditor's report, and provides guidance indicating that an appropriate time limit for this would ordinarily be 60 days after the date of the auditor's report. The revised ISA also resulted in the establishment of a new requirement in ISQC 1, Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements, for firms to set up policies and procedures for the timely completion of the assembly of the final engagement files.
- It establishes a new requirement that the auditor not delete or discard audit documentation after the final audit file has been assembled, unless the retention period for the audit documentation has elapsed. The revised ISA also resulted in expanded guidance in ISQC 1 on the retention of engagement documentation. This guidance indicates that the retention period for audits ordinarily is no shorter than 5 years from the date of the auditor's report, or if later, the date of the group auditor's report.

### Review of Interim Financial Information Performed by the Independent Auditor of the Entity (ISRE 2410)

This new international standard on review engagements (ISRE) establishes standards and provides guidance for auditors that review interim financial information issued by their audit clients. The standard provides guidance on determining the terms of the engagements, procedures, evaluation of misstatements, management representations, and reporting the results of the interim review. In addition, an appendix includes examples of analytical procedures the auditor may consider, and provides illustrative review reports, modified review reports, and a management representation letter.

## 2007

### Preface; ISA 240, 300, 315, and 330

The IAASB has initiated a "clarity project" to run from 2006 to 2011. Under this project, all ISA will be redrafted (in order of importance) and restructured.

For each ISA, the new format will set out the objective(s), and the requirements of the standard and additional guidance (including background information, further explanation, examples of procedures, and general help with implementation). Such guidance is not intended to produce a requirement.

The redrafted preface sets out the above structure of the standards; and ISA 240, 300, 315, and 330 have been redrafted accordingly. All standards redrafted under the clarity project will not become effective before 15 December 2008 at the earliest, giving time for translation.

A further 11 exposure drafts of redrafted (and sometimes revised) standards were produced in 2007.

## 2008

The following exposure drafts were issued for comment in 2008 in the aftermath of the global financial crisis:

- Matters to Consider in a Revision of International Standard on Review Engagements (ISRE) 2400, Engagements to Review Financial Statements
- Proposed Redrafted International Standard on Auditing ISA 210 (Redrafted), Agreeing the Terms of Audit Engagements
- Proposed Redrafted International Standard on Auditing ISA 710 (Redrafted), Comparative Information—Corresponding Figures and Comparative Financial Statements
- Proposed New International Standard on Assurance Engagements Proposed Redrafted International Standard on Auditing
- ISA 501 (Redrafted), Audit Evidence Regarding Specific Financial Statement Account Balances and Disclosures
- Proposed Redrafted International Standard on Auditing ISA 520 (Redrafted), Analytical Procedures
- ISAE 3402, Assurance Reports on Controls at a Third Party Service Organization
- ISA 265, Communicating Deficiencies in Internal Control Proposed Revised and Redrafted International Standard on Auditing ISA 402 (Revised and Redrafted), Audit Considerations Relating to an Entity Using a Third Party Service Organization
- Proposed Revised and Redrafted International Standard on Auditing ISA 505 (Revised and Redrafted), External Confirmations
- Proposed Revised and Redrafted International Standard on Auditing ISA 620 (Revised and Redrafted

Issued by International Ethics Standards Board for Accountants

- Code of Ethics for Professional Accountants
- Section 290 of the IFAC Code of Ethics for Professional Accountants, Independence—Audit and Review Engagements
- Strategic and Operational Plan, 2008–2009

### 2009

Issued by International Ethics Standards Board for Accountants

- Proposed International Accounting Education Standards Board (IAESB) 2010–2012 Strategy and Work Plan
- Explanatory Memorandum on the IAESB Drafting Conventions
- Proposed Framework for International Education Standards for Professional Accountants

## International Federation of Accountants, 2001–2009

IFAC sets standards in four areas: audit and assurance, accounting in the public sector, education, and ethics. It has 155 members in 113 countries, representing 2.4 million accountants.

Since 2001, income has increased from $4 million to $18 million. In 2007, of a total income of $18 million, membership fees accounted for $8 million, and 23 international accounting firms (the "Forum of Firms") contributed $4 million. The direct cost of the IAASB was $3.5 million, but this does not include the value of the substantial amount of work done on a voluntary basis.

In 2005, the Public Interest Oversight Board (PIOB) for accountancy was established in Spain. An independent body, the PIOB oversees the standard-setting process within IFAC to ensure that the standards developed by IFAC's boards in the areas of auditing and assurance, education, and ethics, and IFAC's Member Body Compliance Program are operated in a transparent manner that reflects the public interest. The PIOB receives funding and in-kind support from several organizations, including IFAC and the World Bank.

# Appendix 6
# Regional Seminar Agenda and Attendees

## Enhancing Financial Disclosure Standards in Transitional Economies

### Regional Seminar, Tbilisi, 16–18 November 2009

#### Objectives

A regional seminar was held in Tbilisi on 16–18 November 2009 on Enhancing Financial Disclosure Standards in Transitional Economies. The seminar was financed by the Asian Development Bank (ADB) as part of a regional technical assistance project with Corporate Solutions UK as the project consultants.

Some 35 delegates from various institutions responsible for the development of accounting and auditing standards from Armenia, Azerbaijan, and Georgia attended the seminar. A number of invited speakers from organizations including the International Accounting Standards Board, the Financial Reporting Council, the Association of Certified Chartered Accountants, and Companies House, also participated and spoke at the seminar.

Following the successful conclusion of the country workshops in Baku, Tbilisi, and Yerevan, the regional seminar offered a forum for regulators and standard setters from the three countries to share their knowledge and experience. During the seminar, individual country action plans formulated at the country workshops were refined and regional initiatives identified.

The seminar commenced on Monday 16 November 2009 with an opening session followed by a presentation on the goals and objectives of the seminar and a proposed structure and format for the country action plans.

The seminar covered the following key areas:

- Financial reporting standards
- Auditing standards
- Publication of financial statements
- Monitoring and enforcement
- Education and training and professional bodies

The final session, in the afternoon of 18 November 2009, was dedicated to the presentation of the country action plans and discussions on regional initiatives. This session was chaired by ADB and the panel included representatives from other international financial and donor institutions. The regional seminar's agenda and participants' list is provided in the next pages.

# AGENDA

## Monday, 16 November

### Arrival and Registration

| Time | Agenda Item | |
|---|---|---|
| 10:00–13:00 | Registration | |
| 13:00 –14:00 | Lunch | |

| Time | Agenda Item | Name and Position |
|---|---|---|
| 14:00–14:15 | Opening Welcome | Otar Gorgodze<br>Georgia Financial Supervisory Agency |
| 14:15–14:45 | ADB—Strategy and Initiatives | Radhakrishna Narasimham<br>ADB |
| 14:45–15:00 | Seminar Objectives and Organization | George Brittain<br>Corporate Solutions |
| 15:00–15:30 | Tea break | |
| 15:30–16:00 | Accounting and Auditing ROSC: Regional Issues and Reforms Challenges | Andrei Busuioc<br>World Bank |
| 16:00–16:30 | Action Planning—Structure and Format | George Brittain<br>Corporate Solutions |
| 16:30–18:00 | Accounting and Auditing Reforms<br>• Georgia<br>• Azerbaijan<br>• Armenia | Country Representatives |
| 18:30–20:30 | Cocktails and buffet | |

## Tuesday 17 November

| Time | Agenda Item | Name and Position |
|---|---|---|
| 09:00–09:45 | IFRS—An Overview | Mike Wells<br>IAASB |
| 09:45–10:45 | ISA/IFRS-Based Qualification: The role of professional organization (model of ACCA) | Nataliya Vovchuk<br>ACCA |
| 10:45–11:15 | Tea break | |
| 11:15–12:00 | Financial Reporting Council and Audit Regulation in the United Kingdom | Jon Hooper<br>FRC |
| 12:00–12:30 | Future of Financial Regulation—ACCA's Recommendations | Nataliya Vovchuk<br>ACCA |
| 12:30–13:00 | Round Table Discussions—Regulation: What are the issues and priorities? | Chair: Jon Hooper<br>FRC |
| 13:00–14:00 | Lunch | |

*continued on next page*

Tuesday 17 November *continued*

| Time | Agenda Item | Name and Position |
|---|---|---|
| 14:00 –14:45 | IFRS for SMEs | Mike Wells<br>IAASB |
| 14:45–15:15 | IFAC Education Standards | Jon Hooper<br>IFAC Consultative Advisory Group |
| 15:15–15:45 | Tea break | |
| 15:45–17:00 | Round Table Discussion—Accounting and Auditing Reforms: Where now? | Chair: Andrei Busuioc<br>World Bank |
| 17:00–18:00 | Refining the Country Action Plans | Country Representatives |
| 19:30–22:30 | Dinner | |

## Wednesday 18 November

| Time | Agenda Item | Name and Position |
|---|---|---|
| 9:30–10:30 | Financial Reporting: Rebuilding Trust | Andrei Busuioc<br>World Bank |
| 10:30–11:30 | Publication of Financial Statements | Lynn Lynch<br>Companies House, UK |
| 11:30–12:00 | Tea break | |
| 12:00–12:30 | Financial Reporting—An Institutional Investor's Perspective | EBRD |
| 12:30–13:30 | Lunch | |
| 13:30–14:00 | Country Action Plan—Georgia | Country Representatives |
| 14:00–14:30 | Country Action Plan—Azerbaijan | Country Representatives |
| 14:30–15:00 | Country Action Plan—Armenia | Country Representatives |
| 15:00–15:30 | Tea break | |
| 15:30–17:00 | Round Table Discussions—Action Plans | Chair: Radhakrishna Narasimham<br>ADB |
| 17:00–17:30 | Concluding Remarks | Radhakrishna Narasimham<br>ADB |
| 17:30–18:30 | Departures | |

ACCA = Association of Certified Chartered Accountants, ADB = Asian Development Bank, EBRD = European Bank for Reconstruction and Development, FRC = Financial Reporting Council, IAASB = International Auditing and Assurance Standards Board, IFAC = International Federation of Accountants, UK = United Kingdom.

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**Radhakrishna Narasimham**, a fellow chartered accountant, is the principal financial management specialist in the Financial Sector, Public Management and Trade Division of the Central and West Asia Department of the Asian Development Bank (ADB). Working closely with counterparts in Armenia, Azerbaijan, and Georgia, he conceptualized the technical assistance project, analyzed insightfully the challenges faced by the three countries in enhancing financial disclosure standards, and outlined measures to achieve this goal.

**Enhancing Financial Disclosure Standards in Transitional Economies II**

Public and private investors want timely, accurate financial information about institutions before investing. This requires adherence to internationally accepted financial disclosure standards. However, implementing these standards is a particular challenge for economies in transition from the Soviet-era central planning approach toward a market economy.

The Asian Development Bank provided a technical assistance grant (TA 6505-REG) to build capacity to enhance financial disclosure standards in Armenia, Azerbaijan, and Georgia.

The book is a compendium of the project's findings, activities, results, and recommendations. It discusses the rationale for the adoption of International Financial Reporting Standards and the enforcement of International Standards on Auditing by legal entities, and explores their use by small and medium-sized enterprises in the three countries. The book is a valuable guide to accountants, auditors, financial institutions, regulators, investors, governments, researchers, and others interested in financial disclosure practices and progress of these transitional nations.

**About the Asian Development Bank**

ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries substantially reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to two-thirds of the world's poor: 1.8 billion people who live on less than $2 a day, with 903 million struggling on less than $1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

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