Diagnostic Study of Accounting and Auditing Practices in Selected Developing Member Countries

Azerbaijan
Fiji Islands, Republic of the
Marshall Islands
Philippines
Sri Lanka

Prepared Under Regional Technical Assistance (RETA) 5980: *Diagnostic Study of Accounting and Auditing Practices in Selected Developing Member Countries*

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Foreword

A rapidly growing body of compelling economic research reveals that governance arrangements strongly influence development outcomes including social indicators such as infant mortality and adult literacy rates. Sound accounting and auditing practices are an integral part of good governance arrangements.

Moreover, the 1997-98 East Asian financial crisis taught us a lot about the way structural weaknesses of institutions, bad regulatory policies and poor supervision of financial institutions can have huge costs, even where macroeconomic management is fundamentally sound. It taught us that good governance in both the public and private sectors is very important. Good corporate governance requires the enforcement of bankruptcy and corporate laws, the use of internationally acceptable accounting and auditing standards, and the existence of independent auditors and regulators.

These lessons are relevant for all countries; not just those from East Asia. Even the United States—which has a strong financial market framework—is currently struggling with a string of financial governance failures. The Asian Development Bank (ADB) heeded these lessons and identified two key reform priorities: strengthening banking supervision and regulation, and improving financial reporting standards and their enforcement.

If ADB is to provide effective assistance to address these priority areas, we must first understand each country's existing accounting and auditing arrangements and the particular challenges they face. To get this understanding, Diagnostic Studies of Accounting and Auditing (DSAAs) were undertaken for seven developing member countries (DMCs) in 2000; Cambodia, People's Republic of China, Mongolia, Pakistan, Papua New Guinea, Uzbekistan and Viet Nam. These studies were conducted in consultation with governments, other donor agencies and the accounting and auditing professions. Each country study identified issues and developed actions to remedy revealed weaknesses.

The first seven diagnostic studies were particularly successful. Indeed the People's Republic of China study had to be reprinted within weeks of its release to meet high demand. The studies did not end with report publication. In most cases, the participating governments are acting to implement the recommendations. In some cases, ADB is providing relevant assistance to the participating governments.

Given this success, ADB management agreed to extend the diagnostic work undertaken in 2000 to five additional DMCs: Azerbaijan, Fiji Islands, Marshall Islands, Philippines and Sri Lanka.[1] This report summarizes the results of the individual country studies. Each country has a different background and faces its own challenges. Four are island nations and one is landlocked. Two countries have British accounting backgrounds, one has a Soviet accounting history and two have been influenced by American arrangements. Whatever their differences, all five are committed to improving their accounting and auditing practices.

Sound accounting and auditing arrangements are not just important for avoiding crises. Good arrangements reduce opportunities for growth-sapping corruption. They also enable countries to attract investment and to develop at a faster pace. The studies, which this report summarizes, were conducted between January 2001 and March 2002 in consultation with other donor agencies, government organizations, and accounting and auditing professions. The studies identified gaps and weaknesses in the current accounting and auditing infrastructure of the five countries and came up with recommendations and action plans to remedy the identified weaknesses. ADB intends to develop such profiles for other DMCs in the future.

Ifzal Ali
Chief Economist
Economics and Research Department
Asian Development Bank

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[1] The DSAAs for Azerbaijan, Fiji Islands, Marshall Islands and Sri Lanka were prepared under ADB Regional Technical Assistance (RETA) 5980: *Diagnostic Study of Accounting and Auditing Practices in Selected Developing Member Countries*. The Philippines DSAA was prepared under ADB RETA 5765: *Banking, Capital Market and International Competitiveness Reforms in Response to the Currency Turmoil*.

Preface

This report was prepared under Regional Technical Assistance (RETA) 5980: *Diagnostic Study of Accounting and Auditing Practices in Selected Developing Member Countries* for ADB by Francis B. Narayan, Lead Financial Management Specialist, ADB; Sarath Lakshman Athukorala, Financial Management Specialist, ADB; and Barry C. Reid, Consultant, ADB. Maria Rosa (Bing) P. Ortega, ADB coordinated logistical arrangements.

This report summarizes the results of DSAAs in five ADB DMCs: Azerbaijan, Fiji Islands, Marshall Islands, Philippines and Sri Lanka.[2] Individual reports are also available for each of the five countries. These studies extend work conducted in 2000, when DSAAs were prepared and published for seven ADB DMCs: Cambodia, People's Republic of China, Mongolia, Pakistan, Papua New Guinea, Uzbekistan and Viet Nam.[3]

The World Bank has a similar initiative in their Country Financial Accountability Assessment (CFAA) program. These exercises are generally coordinated to avoid overlap. For instance, the World Bank used the Sri Lankan DSAA as the basis for their public sector-focused CFAA.

The individual country studies were undertaken between January 2001 and February 2002. The issues and recommendations identified in each country report were discussed and debated with representatives from government, the private sector and international organizations at workshops in each of the participating countries. The reports were also reviewed by government officials, private sector representatives, ADB officials, and officials from other bilateral and multilateral donor organizations. The study results and recommendations were further discussed and debated at an international workshop at ADB headquarters in Manila on 5-6 March 2002. In the coming months, ADB will work with each respective government and other donor agencies to identify funding sources to support the implementation of the study recommendations, where appropriate.

The authors would like to offer their appreciation to the numerous officials, researchers and agencies that gave up their valuable time and made

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2 The DSAAs for Azerbaijan, Fiji Islands, Marshall Islands and Sri Lanka were prepared under ADB Regional Technical Assistance (RETA) 5980: *Diagnostic Study of Accounting and Auditing Practices in Selected DMCs.* The Philippine DSAA was prepared under ADB RETA 5765: *Banking, Capital Market and International Competitiveness Reforms in Response to the Currency Turmoil.*

3 Under ADB RETA 5877: *Strengthening Financial Management and Governance in Selected DMCs.*

materials available during the course of the research. We would particularly like to thank: Ping Yung Chiu (Controller, ADB), Dezider Stefunko (United Nations Conference on Trade and Development, UNCTAD), Jean-Pierre A. Verbiest (Assistant Chief Economist, Macroeconomics and Finance Research Division, Economics and Research Department, ADB) and Ranel T. Wijesingha (President, Confederation of Asian and Pacific Accountants, CAPA), for their presentations at the Manila international workshop; Abbas Allahverdiyev (Deputy Chair, Azerbaijan Chamber of Accounting), Professor V. Novruzov (Chair, Azerbaijan Chamber of Auditors), Elkhan Jafarov (Head, Accounting Policy Department, Azerbaijan Ministry of Finance), Eroni Vatuloka (Auditor General of Fiji), Paula Uluinaceva (Acting Director, Budget Management, Fiji Ministry of Finance and National Planning), Franklin Henry (Federal Grants Coordinator, Budget Division, Marshall Islands Ministry of Finance), Erma W. Myazoe (Chief Accountant, Marshall Islands Ministry of Finance), Antonieta Fortuna-Ibe (Chair, Philippine Professional Regulation Commission), Carlito Fuentespina (President, Philippine Institute of Certified Public Accountants), Tito S. Nabua (Director, Region IV, Philippine Commission on Audit), Purita A. Fajilan (Consultant, SEC), V. Kanagasabapathy (Additional Director General, Sri Lankan Department of Public Finance), A.D.B. Talawatte (President, Institute of Chartered Accountants of Sri Lanka), for their attendance and presentations at the Manila international workshop; Elaine Glennie (Financial Management Specialist, ADB), Peter N. King (Director, Pacific Operations Division, ADB), Thuy Mellor (Financial Management Specialist, ADB), Masaaki Nagata (Principal Programs Officer, Operations Coordination Division, South Asia Department, ADB), Richard Ondrik (Senior Programs Officer, Philippines Country Office, ADB), Kunio Senga (Director, Operations Coordination Division, East and Central Asia Department, ADB), Robert Y. Siy Jr. (Director, Pacific Operations Division, ADB), Neside Tas-Anvaripour (Financial Management Specialist, ADB) and Samiuela T. Tukuafu (Financial Management Specialist, Mekong Department, ADB), for chairing, moderating or supporting sessions at the Manila international workshop; and Yvonne Osonia, Aileen Pangilinan and Maria Carolina Faustino-Chan for their support throughout the study.

For further information, please visit ADB's website at www.adb.org or contact:

Sarath Lakshman Athukorala
Financial Management Specialist
Asian Development Bank
6 ADB Avenue
Mandaluyong City, Metro Manila
P. O. Box 789
0980 Manila, Philippines

Tel. (632) 632-6626
Fax: (632) 636-2365
E-mail: slathukorala@adb.org

ADB Diagnostic Studies on Accounting and Auditing

The Asian Development Bank (ADB) publishes this series to: (i) provide reference materials on accounting and auditing for government officials, ADB officials, officials from other donor agencies, and other interested parties; (ii) identify potential actions that the participating government and / or the accounting profession can take to rectify weaknesses, in partnership with donor agencies where appropriate, and (iii) provide the participating country with a benchmark against which to measure their progress in improving financial management and governance arrangements.

Orders can be placed with the Publications Information Center, Office of External Relations, ADB, P.O. Box 789, 0980 Manila Philippines. The reports may also be downloaded from www.adb.org.

Summary Reports

Accounting and Auditing Practices in Selected Developing Member Countries (DMCs): A Diagnostic Study of Azerbaijan, Fiji Islands, Marshall Islands, Philippines and Sri Lanka. 2002.

Financial Management and Governance Issues in Selected Developing Member Countries (DMCs): A Study of Cambodia, People's Republic of China, Mongolia, Pakistan, Papua New Guinea, Uzbekistan, and Viet Nam. 2000.

Individual Reports: By ADB Region

All ADB DMCs are listed by region. Economies for which a DSAA has been prepared are bolded and the year of publication is shown in brackets:

East and Central Asia: **Azerbaijan** (2002); **People's Republic of China** (2000); Hong Kong, China; Kazakhstan; Kyrgyz Republic; Republic of Korea; **Mongolia** (2000), Tajikistan; Taipei,China; Turkmenistan; and **Uzbekistan** (2000).

Mekong: **Cambodia** (2000), Lao People's Democratic Republic, Myanmar; Thailand, **Viet Nam** (2000).

Pacific: Cook Islands, Democratic Republic of East Timor, **Fiji Islands** (2002), Kiribati, Republic of the **Marshall Islands** (2002), Federated States of Micronesia, Nauru, **Papua New Guinea** (2000), Samoa, Solomon Islands, Tonga, Tuvalu, Vanuatu.

South Asia: Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, **Pakistan** (2000), **Sri Lanka** (2002).

Southeast Asia: Indonesia, Malaysia, **Philippines** (2002), Singapore.

ABBREVIATIONS

AAC	Azerbaijan Accounting Chamber
AASC	Accounting and Auditing Standards Committee (Fiji Islands)
AATSL	Association of Accounting Technicians of Sri Lanka
ACAAz	Association of Certified Accountants of Azerbaijan
ADB	Asian Development Bank
AICPA	American Institute of Certified Public Accountants
ANB	Azerbaijan National Bank
APEC	Asia Pacific Economic Cooperation
ASC	Accounting Standards Council
ASEAN	Association of Southeast Asian Nations
ASPC	Auditing Standards and Practices Council
AusAID	Australian Agency for International Development
AuSC	Auditing Standards Committee
BIR	Bureau of Internal Revenue (Philippines)
BOA	Board of Accountancy (Philippines)
CAPA	Confederation of Asian and Pacific Accountants
CFA	Compact of Free Association (RMI)
CFAA	Country Financial Accountability Assessment (World Bank)
CHED	Commission on Higher Education (Philippines)
CICPA	Chinese Institute of Certified Public Accountants
CIDA	Canadian International Development Agency
CMASL	Society of Certified Management Accountants of Sri Lanka
CMI	College of the Marshall Islands
COA	Commission on Audit (Philippines)
COAA	Chamber of Auditors of Azerbaijan
CPA	Certified Public / Practicing Accountant
CPE	Continuing Professional Education
DMC	Developing Member Country (ADB)
DSAA	Diagnostic Study of Accounting and Auditing (ADB)
EBRD	European Bank for Reconstruction and Development
ED	Exposure Draft
EFTS	Equivalent Full-Time Student
EU	European Union
EU-TACIS	European Union—Technical Assistance to the Commonwealth of Independent States
FAS	Fiji Accounting Standard

FASB	Financial Accounting Standards Board (US)
FATF	Financial Action Task Force on Money Laundering
FDB	Fiji Development Bank
FDI	Foreign Direct Investment
FFMRP	Fiscal and Financial Management Reform Program (RMI)
FIA	Fiji Institute of Accountants
FIT	Fiji Institute of Technology
FMR	Financial Management Reform
FNTC	Fiji National Training Council
FSU	Former Soviet Union
GAAP	Generally Accepted Accounting Principles
GAAS	Generally Accepted Auditing Standards
GASB	Government Accounting Standards Board (US)
GATS	General Agreement on Trade in Services (WTO)
GDP	Gross Domestic Product
GFS	Government Finance Statistics (IMF)
GNP	Gross National Product
IAASB	International Auditing and Assurance Standards Board (IFAC)
IAPC	International Auditing Practices Committee (IFAC)
IAPS	International Auditing Practice Statement (IAASB)
IAS	International Accounting Standard (IASB)
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IASCF	IASC Foundation
ICASL	Institute of Chartered Accountants of Sri Lanka
IEG	International Education Guideline (IFAC)
IES	International Education Standard (IFAC)
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standard (IASB)[4]
IIA	Institute of Internal Auditors
IMF	International Monetary Fund
INTOSAI	International Organization of Supreme Audit Institutions
IPFDA	Institute of Public Finance and Development Accountancy (Sri Lanka)

[4] In 2001, the International Accounting Standards Board (IASB) assumed responsibility from the International Accounting Standards Committee (IASC) for promulgating IASs. In future, IASB-issued standards will be called International Financial Reporting Standards (IFRSs). While the IASB now expects its standards to be called IFRSs, this report uses the term IASs (in the interests of continuity).

IPSAS	International Public Sector Accounting Standard (IFAC)
IRFAA Eurasia	International Regional Federation of Accountants and Auditors Eurasia
ISA	International Standard on Auditing (IAASB)
ISAR	Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (UNCTAD)
LIFO	Last-in First-out (inventory valuation method)
MIITF	Marshall Islands Intergenerational Trust Fund
MOF	Ministry of Finance
MOFANP	Ministry of Finance and Planning (Fiji Islands)
MTEF	Medium-Term Expenditure Framework
NZAID	New Zealand Agency for International Development
OAG	Office of the Auditor General
OECD	Organisation for Economic Cooperation and Development
OGA	Office of the General Accountant (Philippines)
PFMA	Public Finance Management Act (Fiji Islands)
PFTAC	Pacific Financial Technical Assistance Center
PICPA	Philippine Institute of Certified Public Accountants
PRC	Professional Regulation Commission (Philippines)
PSC	Public Sector Committee (IFAC)
RETA	Regional Technical Assistance (ADB)
RMI	Republic of the Marshall Islands
ROSC	Report on the Observance of Standards and Codes (IMF/World Bank)
SAI	Supreme Audit Institution
SASP	Statements of Auditing Standards of the Philippines
SEC	Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standards
SLAASMB	Sri Lanka Accounting and Auditing Standards Monitoring Board
SLAS	Sri Lankan Accounting Standard
SME	Small or Medium-sized Enterprise
SME-CG	Consultative Group of Experts on SME Accounting (ISAR)
SNA	System of National Accounts (UN)
TA	Technical Assistance
UK	United Kingdom
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
US	United States

USAID	United States Agency for International Development
USP	University of the South Pacific
VFM	Value for Money
WTO	World Trade Organization

Note

In this report, $ refers to US dollars.

Contents

Appendixes

I. Introduction

The 1997-98 Asian financial crisis exposed structural weaknesses in the banking and corporate sectors of affected countries owing largely to poor governance, a lack of transparency, and weak supervision and regulation.[5]

ADB has been taking initiatives to assist its DMCs to overcome these structural problems. The focus on improved governance includes enhancing the effectiveness of public administration and development management at the sector level and in national institutions. Where appropriate, institutional development of the local and provincial agencies and the private sector is also covered. A sound regulatory financial framework and its enforcement, capable institutions, skilled human resources, and effective monitoring and supervision are important prerequisites to an efficient financial structure.

In 2000, under ADB Regional Technical Assistance (RETA) 5877[6], DSAAs were prepared and published for Cambodia, Mongolia, Pakistan, Papua New Guinea, People's Republic of China, Uzbekistan and Viet Nam. ADB approved RETA 5980—*Diagnostic Study of Accounting and Auditing Practices in Selected Developing Member Countries*[7]—for the purpose of carrying out initial studies to identify gaps and weaknesses in accounting and auditing arrangements and to recommend courses of action to overcome these problems. It extends the work conducted under RETA 5877 and involved the preparation of DSAAs for Azerbaijan, Fiji Islands, Republic of the Marshall Islands (RMI) and Sri Lanka.[8] Objectives were to: (i) assess the capability and capacity within each country to provide efficient and effective accounting and auditing support to meet international standards and best practices and address the issue of training and capacity enhancement; (ii) determine the existing accounting and auditing standards of each selected country; (iii) assess the degree of deviation from international accounting and auditing standards while identifying weaknesses and possible corrective options; (iv) discuss the fieldwork findings and introduce the concepts of the international standards through

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5 Zhuang, Juzhong, David Edwards, David Webb and Ma. Virginita Capulong. 2000. *Corporate Governance and Finance in East Asia: A Study of Indonesia, Republic of Korea, Malaysia, Philippines and Thailand*. Manila: ADB.

6 *Strengthening Financial Management and Governance in Selected DMCs.*

7 For $230,000 approved on 20 March 2001.

8 The Philippine DSAA was prepared under RETA 5765 *Banking, Capital Market and International Competitiveness Reforms in Response to the Currency Turmoil.*

workshops; and (v) determine the level and type of assistance needed by each country in order to provide acceptable accounting and auditing support to the private and public sectors.

Each DSAA involved an indepth study of the key issues relating to accounting and auditing support in the selected DMC. Where appropriate, efforts were made to ensure that DSAA exercises were coordinated with World Bank activities to minimize overlap (i.e., for Azerbaijan, the Philippines and Sri Lanka).

The first part of each country study examined accounting and auditing structures and systems. It also: (i) analyzed the political, institutional, and regulatory and legal framework on accounting and auditing practice, and the level of enforcement of existing laws, rules and regulations; (ii) identified gaps and weaknesses in accounting and auditing support available, and deviations from international standards; and (iii) identified alternative options to remedy the identified weaknesses, with the objective of eventually doing away with these.

The second part of each study disseminated the country-research findings through in-country workshops. Each workshop provided a cross-section of views on the research findings and established ways to move forward to improve accounting and auditing arrangements. The overall study results and recommendations were further discussed and debated at an international workshop at ADB headquarters in Manila on 5-6 March 2002.

This report examines selected accounting and auditing issues and summarizes the results of the five country studies. It was finalized following the March 2002 Manila workshop. In addition to this introduction, the report has the following chapters:

- **Chapter II** examines the importance of sound accounting and auditing practices.
- **Chapter III** provides contextual background information on the five countries that participated in the study.
- **Chapter IV** identifies and examines selected accounting and auditing issues.
- **Chapters V-IX** describe the situation in each country, identify weaknesses and present corrective recommendations to address these weaknesses.
- **Chapter X** presents the country action plans and examines region-wide issues.

II. Importance of Sound Accounting and Auditing Practices

1. Introduction

Governance arrangements affect development outcomes. One examination of 175 economies found strong positive relationships between good governance arrangements and per capita incomes, infant mortality rates and literacy rates.[9] Another study reinforced evidence that while gross domestic product (GDP) growth is the most powerful poverty reducer, it is not enough; among other things, countries can double their living standards by improving their legal systems and combating corruption, special emphasis should be placed on deepening domestic financial markets, strengthening regulation and financial supervision, and introducing effective corporate governance mechanisms.[10] There is certainly a strong correlation between an economy's number of accountants and per capita income (see Figure 1).

Accounting and auditing practices underpin governance arrangements. This chapter reviews evidence that sound accounting and auditing mechanisms: (i) attract investment; (ii) support financial market development; (iii) reduce country risk premiums; (iv) improve privatization outcomes; and (v) lower the risk of financial crises, but when crises do occur, reduce their severity and duration.

2. Attracting Investment

In 2001, despite an estimated 42 percent fall in global Foreign Direct Investment (FDI) to $760 billion, net FDI flows to emerging market countries were estimated to have held steady at $163 billion.[11]

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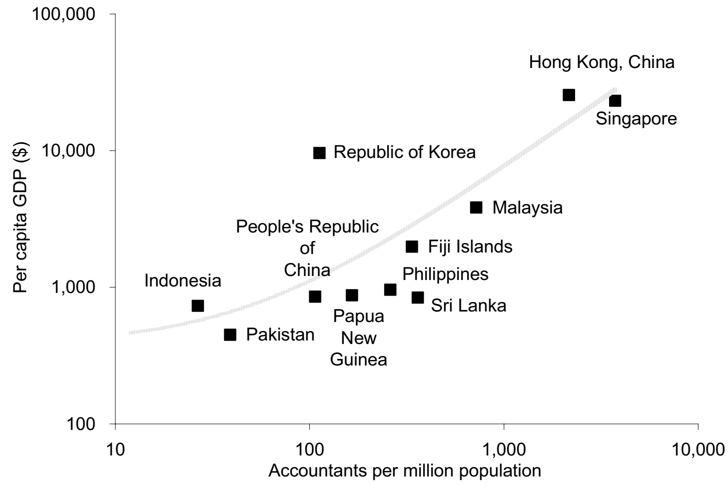
9 Kaufmann, Daniel, Aart Kraay and Pablo Zoido-Lobatón. 2002 February. Governance *Matters II: Updated Indicators for 2000/01*. World Bank Policy Research Working Paper No. 2772. Kaufmann, Daniel, Aart Kraay and Pablo Zoido-Lobatón. 1999 October. *Governance Matters*. World Bank Policy Research Working Paper No. 2196.

10 Thomas, Vinod, Ashok Dhareshwar, Ramon E. Lopez, Yan Wang, Nalin Kishor, Mansoor Dailimi, and Daniel Kaufmann. 2000 August. *The Quality of Growth*. World Bank and Oxford University Press.

11 IMF. 2001. *World Economic Outlook: December 2001*. World Economic and Financial Surveys. Washington: IMF.

However, the International Monetary Fund (IMF) expects net FDI flows to emerging markets to reduce.[12]

Figure 1: Accountants and Per Capita GDP (2000-02)



Various sources including: ADB. 2001. *Key Indicators of Developing Asian and Pacific Countries. Volume XXXII*. Manila: ADB; ADB Diagnostic Studies of Accounting and Auditing.

A recent cross-country survey of institutional investors revealed that most are prepared to pay a premium for companies exhibiting high governance standards. Premiums averaged 12-14 percent in North America and Western Europe, 20-25 percent in Asia and Latin America, and over 30 percent in Eastern Europe and Africa. More than a third stated they would avoid investments in countries with poor governance. Importantly, the survey reveals that accounting practices strongly influence investor decisions (see Figure 2).[13]

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[12] IMF. 2002 March. *Global Financial Stability Report: Market Developments and Issues.* World Economic and Financial Surveys. Washington: IMF. pp. 21-22.

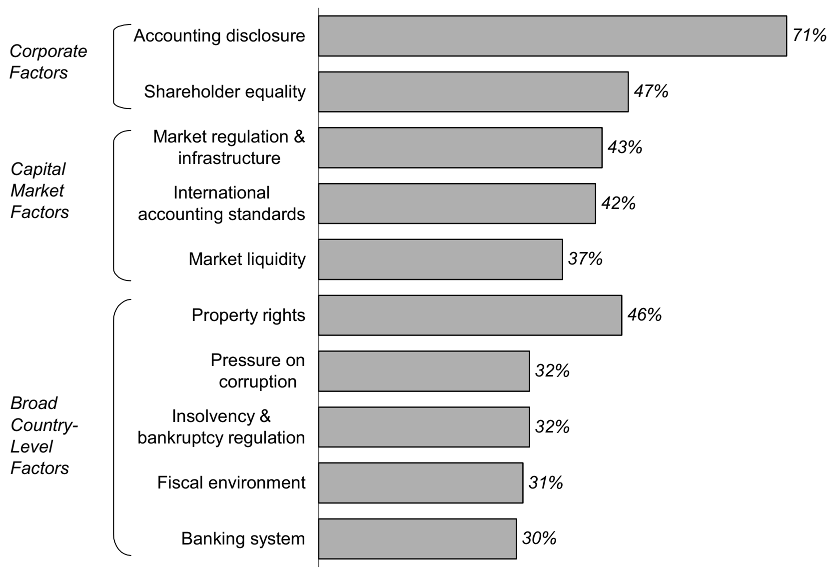
[13] McKinsey & Company. 2002 July. *Global Investor Opinion Survey on Corporate Governance: Key Findings.*

3. Supporting Financial Market Development

Financial markets (arguably) facilitate economic development through more efficient allocation of capital.[14] It is contended that sound accounting and auditing arrangements encourage financial market development.[15]

Figure 2: Very Important Factors Influencing Investor Decisions

McKinsey & Company asked 200 major institutional investors from Africa, Asia, Europe, North America and South America to identify very important factors that influenced their investment decisions. The top ten factors—and the percentage of respondents who included these factors in their top ten list—are shown.



Source: McKinsey & Company. 2002 July. *Global Investor Opinion Survey on Corporate Governance: Key Findings*.

14 See, for instance: Schumpeter, J. A. 1911. *A Theory of Economic Development*. Cambridge, MA: Harvard University Press; King, R. and R. Levine. 1993. Finance and Growth: Schumpeter Might Be Right. *Quarterly Journal of Economics.* Vol. 108: pp. 681-737; Rajan, R. and L. Zingales. 1998. Which Capitalism? Lessons from the East Asian Crisis. *Journal of Applied Corporate Finance*. Vol. 11. pp. 40-48.

15 See, for instance: Barth, M., G. Clinch, and T. Shibano. 1999 January. International Accounting Harmonization and Global Equity Markets. *Journal of Accounting and Economics*. Vol. 26. pp. 201-235; Most, K. 1972 October. Sombart's Propositions Revisited. *The Accounting Review*. Vol. 47. pp. 722-734; Watts, R. and J. Zimmerman. 1983 October. Agency Problems, Auditing, and the Theory of the Firm: Some Evidence. *Journal of Law and Economics*. Vol. 26. pp. 613-634; Yamey, B. 1964. Accounting and the Rise of Capitalism: Further Notes on a Theme by Sombart. *Journal of Accounting Research*. Spring (2). pp. 117-136.

> "High quality accounting standards result in greater investor confidence, which improves liquidity, reduces capital costs and makes fair market prices possible."
>
> – Arthur Levitt (1998), p. 81.[16]

Indeed, a recent study found that higher quality accounting and auditing practices are positively associated with financial market development in countries with stronger legal protection.[17]

Furthermore, developing and transitional countries often have weak investor protection laws, which are associated with concentrated ownership, lower levels of outside (minority) ownership and less developed financial markets.[18] It has been suggested that weak investor protection may be more effectively addressed through strengthened accounting and auditing practices, rather than by more-difficult-to-implement legal reforms.[19]

4. Lowering Country Risk Premiums

In early 2001, PricewaterhouseCoopers (PwC), an international consulting firm, produced an *Opacity Index*. This measure weighs the effects of unclear legal systems and regulations, macroeconomic and tax policies, accounting standards and practices, and corruption on the capital markets of 35 countries. Russia is the most opaque, and the US and Singapore the most transparent.[20] Opacity generates a country risk premium that deters foreign investors. For example, PwC estimates that the premium on an Indonesian government bond issue, relative to a US one, is more than 10 percent (see Figure 3). Some opacity premiums are higher than the actual interest rate at which particular countries are able to borrow. PwC contends that certain capital market dynamics and hidden subsidies explain this apparent anomaly.

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[16] Levitt, Arthur. 1998 March. The Importance of High Quality Accounting Standards. *Accounting Horizons*. Vol. 12. pp. 79-82.

[17] Francis, Jere R., Inder K. Khurana, and Raynolde Pereira. 2002 May. The Role of Accounting and Auditing in Corporate Governance and the Development of Financial Markets Around the World. Paper Presented to the 2002 International Symposium on Audit Research, July 2002, Sydney, Australia.

[18] La Porta, R., F. Lopez-de-Silanes, A. Shleifer, and R. Vishny. 1998 December. Law and Finance. *Journal of Political Economy*. Vol. 106. pp. 1113-1155.

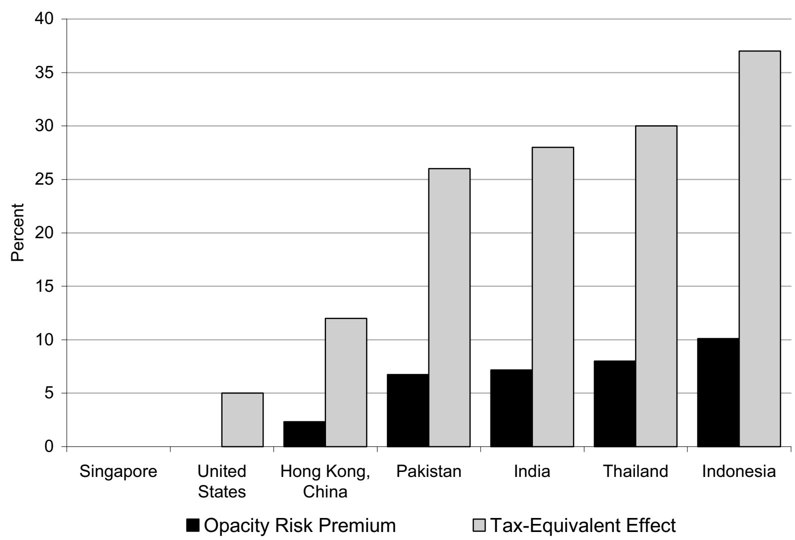
[19] La Porta, R., F. Lopez-de-Silanes, A. Shleifer, and R. Vishny. 2000 February. Agency Problems and Dividend Policies Around the World. *Journal of Finance*. Vol. 55. pp. 1-33.

[20] *The Economist*. 2001 March 1. Transparency. p. 110.

The *Opacity Risk Premium* indicates the increased cost of borrowing faced by countries due to opacity. On average, countries with more opacity pay higher interest rates on issued debt. For example, a score of nine indicates that countries need to pay international investors an extra 9 percent on their sovereign debt due to opacity.

The *Tax Equivalent Effect* estimates opacity impacts when viewed as a hidden tax. For example, the number 30 indicates that opacity in that country is equivalent to levying an additional 30 percent corporate income tax. The best-practice country is scored at zero and serves as the benchmark (i.e., US and Singapore for opacity, and Singapore for the tax equivalent effect).[21]

Figure 3: Estimated Opacity Effects: Seven Selected Economies



Source: PricewaterhouseCoopers. 2001 January. *The Opacity Index*. PwC Worldwide.

5. Improving Privatization Outcomes

Country and enterprise accounting systems, financial information and audit methodologies, play a critical role in the success of privatizations. However, the accounting structures and processes of many government enterprises are inadequate.

[21] The Opacity Factors for Singapore and the US are 29 and 36, respectively. Although the study assigns zero *Opacity Risk Premiums* to both countries, it differentiates for *Tax Equivalent Effects* (i.e., Singapore is scored at zero and the US at five).

Evidence suggests that privatization will be more difficult if financial management issues are not addressed beforehand. There is also evidence that unreliable or inadequate financial information can reduce privatization proceeds, through valuation difficulties.[22]

6. Reducing Crisis Risks and Mitigating Crisis Effects

An ADB study found that poor enforcement of corporate regulations, underdeveloped capital markets and high concentrations of corporate ownership were the main reasons for weak corporate governance in the economies that were most affected by the 1997-98 Asian financial crisis.[23] It recommended: (i) rationalizing corporate ownership structures (ownership concentration should be reduced); (ii) bolstering corporate internal controls and shareholder protection; (iii) improving external monitoring and discipline; and (iv) developing capital markets and improving the efficiency of corporate financing. The study concluded that measures to strengthen corporate internal control, improve standards of accounting, auditing and financial reporting systems and their enforcement "should be placed on top of the reform agenda".[24]

There is also evidence that the buildup, duration, and severity of bubbles in equity and real estate markets, as well as the restructuring that occurs in their aftermath, are related to the availability of skills in financial sector services. Countries that have capable professionals such as accountants, appraisers, analysts and insolvency experts, recognize and respond more swiftly to asset bubbles than countries with limited financial sector skills.[25, 26]

[22] See, for instance, Enthoven, Adolf. 1998. Privatization and the Role and Impact of Accounting and Auditing. University of Texas at Dallas: Paper presented at 21st EAA Congress: Accounting in Times of Transition. Antwerp, April 1998.

[23] Zhuang, Juzhong, David Edwards, David Webb and Ma. Virginita Capulong. 2000. *Corporate Governance and Finance in East Asia: A Study of Indonesia, Republic of Korea, Malaysia, Philippines and Thailand*. Manila: ADB.

[24] *Ibid*, p. 86.

[25] Allen, Franklin and Douglas Gale. 2000 January. Bubbles and Crises. *Economic Journal*. 110. pp. 236-55.

[26] Pomerleano, Michael (Lead Financial Specialist, World Bank). 2002 April. Back to the Basics: Critical Financial Sector Professions Required in the Aftermath of an Asset Bubble. *The Appraisal Journal*. pp. 173-181.

> "The strong correlation among the base of skills, the growth of non-bank financial intermediation and the stability of the financial system suggests that poor prevention and weak responses to financial crises are linked to inadequate skills and human capital in the financial services sector." [27]

7. Conclusion

This chapter reviewed evidence that sound accounting and auditing practices support economic development. The importance of accounting and auditing arrangements should not be understated; even minor reductions in a country's risk premium will free up significant public sector resources (by reducing debt-servicing payments) and make more private sector investments viable (by lowering investment-hurdle rates).

[27] *Ibid.* p. 175.

III. Participating Country Backgrounds

1. Introduction

The ADB has 41 DMCs. In 2001, five were approached and invited to participate in a Diagnostic Study of Accounting and Auditing (DSAA). All accepted the invitation. The decision to invite this particular group was based on several factors including their willingness to participate, geographical location, involvement in the World Bank Country Financial Accountability Assessment (CFAA) exercise, stage of development and the extent of ADB assistance. It was intended that the participating countries should represent a cross-section of all ADB DMCs.

This chapter presents background information on the five DMCs. It provides context for the following chapters, which examine individual country accounting and auditing practices.

2. Comparative Information

The information presented in Table 1 illustrates the social and economic similarities and differences between the five DMCs.

Table 1: Comparative Information on the Participating DMCs [28,29]

Indicator	Azer-baijan	Fiji Islands	Philip-pines	RMI	Sri Lanka
General					
Population *(thousands, 2000)*	8,049.0	811.0	78,400.0	52.0	19,359.0
Population density (*people per km^2, 2000)*	93.0	44.0	263.0	282.0	295.0
Urban population (*% of total, 2000)*	57.3	42.3	58.6	71.9	23.6
Average annual population growth rate *(%, 1995-2000)*	1.0	1.1	2.2	1.5	1.3
Social					
Under-five mortality rate *(per 1000, 1999)*	16.0	18.0	31.0	63.0	15.0
Life expectancy at birth *(years, 1999)*	71.0	67.0	69.0	65.0	74.0
Adult literacy rate *(15-yr+, %, 1999):*					
– Females	97.0	90.0	95.0	97.0	89.0
– Males	97.0	95.0	95.0	97.0	94.0
Population in poverty *(%, 1995-99)*	68.1	25.5	40.0	...	26.7
Human Development Index *(1999)*	0.74	0.76	0.75	0.56	0.74

28 ADB. 2001. *Key Indicators of Developing Asian and Pacific Countries*. Volume XXXII. Manila: ADB.

29 ADB. 2001. *Asian Development Outlook 2001*. Manila: ADB. pp. 139-140.

Table 1: Comparative Information on the Participating DMCs *(continued)*

Indicator	Azer-baijan	Fiji Islands	Philip-pines	RMI	Sri Lanka
Economic					
Gross National Product (GNP)(*$million, 1999)*	3,705.0	1,848.0	77,967.0	99.0	15,578.0
GDP per capita *($, 2000)*	654.0	1,978.0	959.0	1,890.0	842.0
GDP growth rate (%) – 2000	11.4	-9.3	4.0	-2.3	6.0
– 1999	7.4	9.6	3.4	0.8	4.3
– 1998	10.6	1.4	-0.6	-16.0	4.7
– 1997	8.8	-0.9	5.2	-9.4	6.3
Consumer Price Index *(Annual % change, 2000)*	1.9	1.1	4.4	-1.9	6.2
Fiscal Balance / GDP *(%, 2000)*	-1.0	...	-4.2	-35.5	-9.9
Total External Debt / GNP *(%, 1999)*	30.0	9.3	64.8	...	60.3
Official Development Flows					
$ million *(1999)*	207.2	23.2	295.0	62.9	343.6
Dollars per capita *(1999)*	25.7	28.6	3.8	1,219.0	17.7
Percentage of GNP *(1999)*	5.6	1.3	0.4	63.5	2.2

3. Azerbaijan

Azerbaijan is located in the South Caucasus region, on the western shore of the Caspian Sea. In the 19th century, it experienced an unprecedented oil boom and—by 1900—was supplying almost half of the world's oil.

This oil-rich country's population of about 8 million comprises different ethnic groups, including Azeris, Dagestanis and Russians. It gained independence from the Soviet Union in 1991 amid war and political turmoil—a 1994 ceasefire agreement ended an armed conflict with Armenia. However, about one-seventh of Azerbaijan's territory remains occupied, while around 800,000 refugees and internally displaced persons are scattered throughout the country. Almost 70 percent of the population lives in poverty.

In 1994, Azerbaijan signed a 30-year contract worth $7.4 billion with a British Petroleum-led consortium. A number of production-sharing arrangements have since been negotiated with foreign firms, which have thus far committed $60 billion to oil field development. Oil production under the first production-sharing agreement began in November 1997.

Azerbaijan shares all the problems of other Former Soviet Union (FSU) countries, but its economic reforms were delayed by the unstable domestic situation. Since the mid-1990s, it has made progress towards establishing a market economy and restoring macroeconomic stability. A privatization program was introduced in September 1996. Within three years, over 21,000 small enterprises had passed into private hands. Inflation of 1,500 percent in 1994 was reduced to just 2 percent in 2001.

Overall economic performance has been consistently strong—real GDP growth for 2001 was estimated at 9.9 percent. However, this growth is concentrated in the oil and oil-related sectors. Other sectors remain weak and unemployment was estimated at 18 percent in 2000.

The unresolved conflict impedes economic progress and deters foreign investment. Long-term prospects depend upon world oil price levels, the location of new regional pipelines and Azerbaijan's ability to manage its oil wealth. Maintaining the competitiveness of non-oil exports is a serious long-term challenge.

4. Fiji Islands

The Fiji Islands are located in the southwest Pacific Ocean. Seventy percent of Fiji Islanders reside on the large island of Vitu Levu. The Fiji Islands became a British colony in 1874 and around 60,000 indentured laborers were brought from India to work in the sugarcane fields.

The country's population is now around 811,000 and mainly comprises (indigenous) Fijians (50 percent) and Indo-Fijians (45 percent). The Fiji Islands became independent 1970. In 1987, a military-backed coup d'état removed an elected government from office. Although democracy was restored in 1999, an Indo-Fijian-led government was forced from office in May 2000. Democracy was again restored at the end of 2001.

Since 1987, emigration levels have been extremely high; particularly of skilled and professional personnel. More than 70,000 people emigrated in the aftermath of the 1987 coup. Emigration increased significantly following the events of May 2000.

Although the Fiji Islands is one of the most developed Pacific Island economies, it remains a developing country with a large subsistence agriculture sector. Tourism has expanded rapidly since the early 1980s and is now the leading economic activity. Other significant sectors include sugar and garments; each makes up about one-quarter of export revenues.

The government-owned National Bank of Fiji (NBF) nearly collapsed in the mid-1990s. The subsequent government bailout, while politically inevitable, cost the economy dearly. NBF's collapse was largely due to poor supervision and poor corporate governance.

Aside from political uncertainty, the key economic management issues include the instability of the sugar industry due to expiring land leases and the expected cessation of the Lomé Agreement, poor productivity in the sugar industry, and uncertainty in the garment industry over the future of preferential trading agreements with Australia.

5. Republic of the Marshall Islands

The Republic of the Marshall Islands (RMI) has a population of 51,600. It is situated in the Central Pacific Ocean, between Hawaii and Papua New Guinea. Like several other smaller Pacific countries, RMI is remote from major markets, deficient in both the quality and quantity of land resources, and acutely short of skilled labor, although it does possess potentially rich marine resources built on fish and seabed minerals.

In 1986—after about four decades as a United States (US)-administered United Nations Trust Territory—RMI became a freely associated state with the US, through a Compact of Free Association (CFA). Since then, RMI has received considerable economic and technical assistance from the US. However, the first 15-year CFA expired in September 2001 and a new CFA is currently under negotiation.

In the past 15 years, RMI has made significant progress in developing infrastructure but the economy has been largely stagnant—although GDP increased by 17 percent from 1986 to 1999, the population increased by 35 percent at the same time; the net effect was a decline in per capita income of about 12 percent.

6. Philippines

Around 80 million people live in the Republic of the Philippines—12 million of these reside in the capital Manila. Ethnicity is diverse with people of Chinese, Malay and Spanish descent; more than half the population is aged less than 20 years.

Foreign powers governed the Philippines for almost four centuries up until independence in 1946. The country has had a rocky ride since then. In 1972, President Ferdinand Marcos declared martial law, ostensibly in response to growing unrest, prevalent corruption and high crime levels. Changes were noticeable as crime decreased and public health services improved. But dissatisfaction grew with the dictatorial regime and a nonviolent campaign of civil unrest and national protest culminated with Marcos's exile in February 1986. The Supreme Court and a democratic parliament were subsequently reestablished.

Following economic and financial crises in the late 1980s and early 1990s, the Philippines launched a robust economic reform program—including improved debt management, trade liberalization, privatization, deregulation and financial reforms—that contributed to declining public sector deficits, accelerating growth and rising capital inflows after 1992. By 1996, real GNP was growing at 6.9 percent and poverty had been significantly reduced.

The Philippine economy was among the first to be hit by the Asian financial crisis. The initial symptoms were similar to those in Indonesia, Korea, Malaysia and Thailand and included a loss in investor confidence resulting in large capital outflows, a decline in reserves, stock market collapses and a large currency depreciation. However, the Philippines weathered the crisis relatively well. There was no need for the Government to recapitalize private banks and most large corporations remained solvent. This has been attributed to: (i) relatively sound precrisis capital positions and portfolio quality among banks; (ii) a relatively strong banking regulatory and supervisory framework due to reforms after the 1980s banking crisis; (iii) low debt-equity ratios—by regional standards—in the corporate sector; (iv) less overheated real estate markets; and (v) strong export growth and remittance flows.

Joseph Estrada was elected president in 1998. However, the Japanese economic deterioration combined with uncertainties over the Estrada administration's policies, caused a new downturn that culminated in the September 1998 emerging market crisis. Financial markets subsequently recovered with equity prices up twofold, peso appreciation, a large increase in official reserves and significant declines in interest rates. But, President Estrada, amidst political turmoil in January 2001, was forced out of office. The administration of President Gloria Macapagal Arroyo has professed commitment to economic reform. In the meantime, the Philippines slipped from being one of East Asia's richest countries at independence to one of its poorest today.

7. Sri Lanka

Sri Lanka is located in the Indian Ocean (just off India's southern tip). In 1948—after more than three centuries of colonization—Sri Lanka gained independence from Britain. Back in the 1960s, Sri Lankans had the same per capita income as Koreans, Malaysians and Singaporeans. With a strategic location, strong institutions, sound infrastructure and comparatively high education standards, they faced a promising future.

Indeed, Sri Lanka has achieved human development outcomes more consistent with those of high-income countries. There are now about 19 million Sri Lankans comprising Sinhalese (74 percent), Tamils (18 percent) and Muslims (7 percent). For almost two decades, attempts have been made to resolve a separatist Tamil insurgency in the island's north and east.

Over 60,000 lives have been lost and more than 170,000 people are living in welfare centers. Indirect costs of the conflict include disruptions to commerce, distortions to labor markets and missed revenues from potential investment and tourism—it is estimated that the conflict reduces GDP growth by 2-3 percentage points each year.

The per capita incomes of Koreans, Malaysians and Singaporeans are now several times higher than those of Sri Lankans. Several factors contributed. First, the conflict has taken a heavy social and economic toll. Second, until recently, Sri Lanka had an extremely high population growth rate. Third, public institutions and governance arrangements have gradually weakened since the 1970s. Fourth, Sri Lanka has for many years assigned the public sector a significant role in creating jobs and transferring resources across groups. The size of the public sector has declined slightly over the years, but it continues to dominate the financial sector and utilities, and includes many commercial enterprises. Per capita employment in the public sector is Asia's highest. With public sector productivity typically well below that of the private sector, this has meant missed growth and employment opportunities.

Despite these factors, Sri Lanka is today South Asia's most open economy, and has a relatively well-developed capital market infrastructure. Its per capita income remains the highest in the region, after Maldives. Sri Lanka posted high economic growth rates during the 1990s and weathered the 1997-98 Asian financial crisis reasonably well. However, the global economic slowdown threatens prospects for further improvements.

IV. Selected Accounting and Auditing Issues

1. Introduction

This chapter examines selected accounting and auditing issues. Section two describes moves to develop international guidelines and to monitor their application. Sections three and four examine International Accounting Standards (IAS) and financial reporting for small- and medium-sized enterprises (SMEs). Auditing standards and practices are considered in section five. Section six discusses the need for a strong accountancy profession and associated guidance and training materials. Section seven summarizes recent public sector reporting developments. The chapter concludes with section eight.

2. International Guidelines and Surveillance

The international community is supporting the development of guidelines, standards and codes that promote sound financial management and governance practices (see Table 2).

Table 2: Selected International Guidelines, Standards and Codes

Guideline, Standard or Code	Promulgated By
Principles of Corporate Governance	Organisation for Economic Cooperation and Development (OECD)
Code of Good Practices on Fiscal Transparency	IMF
Code of Good Practices on Transparency of Monetary and Financial Policies	IMF
Implementation of the Objectives and Principles for Securities Regulation assessment surveys	International Organization of Securities Commissions
International Accounting Standards (IAS)	International Accounting Standards Board (IASB)
International Standards on Auditing (ISA)	International Auditing and Assurance Standards Board (IAASB)
Banking Supervision Guidelines	Basel Committee on Banking Supervision (BCSB) of the Bank for International Settlements

These guidelines, standards and codes—to varying extents—all involve accounting and auditing arrangements. Furthermore, to help identify and avoid potential crises before they occur, the IMF and the World

Bank have together embarked on a series of *Reports on the Observance of Standards and Codes (ROSCs)*. ROSCs summarize the extent to which countries observe certain internationally recognized standards.[30] They are intended to be voluntary, but the information provided by each country (or not provided, as the case may be) is likely to influence country dealings with international financial institutions, and the level of confidence that the international financial community has in a country.

3. International Accounting Standards (IAS)

Introduction

The International Accounting Standards Committee (IASC) was established in 1973 to develop and promulgate a set of international accounting standards (IAS). It published the first bound set of IAS in 1987. IAS is intended to enhance the comparability of financial information by reducing national accounting differences. As of July 2002, IAS was available in English and 20 other languages.[31]

In 2001, the IASB superseded IASC and adopted existing IASs. Future IASB-issued standards will be called International Financial Reporting Standards (IFRSs).[32] IASB is funded by contributions from national and international professional accountancy bodies, financial institutions and industrial companies, major accounting firms, central banks and multilateral development banks. As of June 2002, 34 IASs were supplemented by 31 statements issued by the IASB Standing Interpretations Committee (SIC)(see Appendix 2 and Appendix 3, respectively).

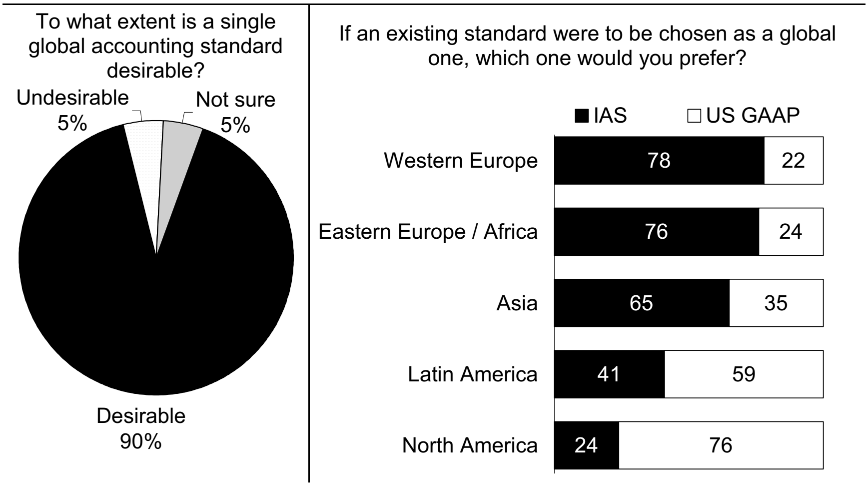
Few countries embraced IAS immediately. Nevertheless, by 2002, many ADB DMCs and more than half of the OECD member economies have either directly adopted, or are in the process of directly adopting, IAS. The G8, International Organization of Securities Commissions and the Bank of International Settlements now endorse it. There is strong support for uniform global accounting standards, although consensus has yet to be reached on the basis for these standards (see Figure 4 and Box 1).

[30] IMF. September 2000. Experimental Reports on Observance of Standards and Codes (ROSCs). www.imf.org/external/np/rosc

[31] Approved translations at July 2002: Arabic, Bulgarian, Chinese, Croatian, Czech, Finnish, French, Georgian, German, Italian, Japanese, Latvian, Macedonian, Polish, Romanian, Russian, Slovak, Slovenian, Spanish and Ukrainian.

[32] While IASB now expects its standards to be called IFRSs, this report uses the term IAS, for continuity.

Figure 4: McKinsey Institutional Investor Survey



Source: McKinsey & Company. 2002 July. *Global Investor Opinion Survey: Key Findings*.

Box 1: Will US GAAP Converge with IAS?

On 30 July 2002, the Public Company Accounting Reform and Investor Protection (Sarbanes-Oxley) Act was signed into US law. Among other things, it requires the US SEC to examine the adoption of principles-based accounting. SEC must report its findings by July 2003 on: (i) the current use of such accounting in the US; (ii) the time required to adopt principles-based accounting; (iii) the feasibility of and proposed methods for introducing such a system; and (iv) an economic analysis of the implementation of principles-based accounting.

The law also permits SEC to look to private-sector accounting standard-setters, such as the Financial Accounting Standards Board (FASB), if they: "consider, in adopting accounting principles, ... the extent to which international convergence on high quality accounting standards is ... appropriate in the public interest and for the protection of investors."

Benefits of Direct IAS Adoption

There is an increasing international trend for direct IAS adoption. Countries who have taken, or who are taking, this path include Australia, Pakistan and European Union (EU) member countries.[33] Direct IAS adoption: (i) reduces accounting standard-setting costs and efforts; (ii) improves the

[33] Subject to government clearance, from 1 January 2005 Australian audit reports will refer to compliance with IASB standards. Australian Financial Reporting Council (FRC). 2002 July 3. Adoption of International Accounting Standards by 2005. *Bulletin of the Financial Reporting Council*. 2002/4.

credibility of country financial reporting, because investors dislike national deviations; and (iii) provides access to a greater range of directly applicable training and guidance materials.

The benefits of access to high quality training materials cannot be overstated, particularly for DMCs. For instance, Deloitte Touche Tohmatsu publishes an excellent set of IAS-compliant model financial statements, which are cross-referenced to IAS (a comprehensive disclosure checklist is also available).[34] Moreover, the anticipated EU adoption of IAS has strengthened demand for training materials and programs. Furthermore, the IASC Foundation (IASCF) intends to certify certain programs as IASCF-approved training.

General Criticisms of IAS

IAS has faced considerable criticism at times. Critics have highlighted their lack of detailed guidance (see Box 2), their perceived Anglo-Saxon bias, the acceptance of alternative accounting treatments within standards and the need for a strong auditing profession to ensure their effective implementation. However, these criticisms are gradually waning or are being addressed. In particular, the 2002 IASB work program centers on addressing issues through the *Improvements Project*.[35]

Box 2: Detailed Standards[36]

The [IASB] has stated that it has no intention of trying to duplicate [US GAAP], and indeed, subscribes to a philosophy of providing general guidance rather than detailed standards addressing every nuance of business practice. There are many who believe that the troubles experienced by accountants in recent years, particularly the explosion of litigation against them, can be traced to the attempt (doomed to fail, some would argue) to establish specific guidance for a vast array of transactions and events.

[34] See www.iasplus.com

[35] The *Improvements Project's* objectives include reducing or eliminating alternatives, redundancies and conflicts within existing IAS and making other improvements to them. This includes dealing with certain convergence issues and incorporating related SICs into relevant IASs, where appropriate. The timetable is to finalize the standards by 2002 year-end.

[36] Epstein, Barry J. and Abbas Ali Mirza. 2001. *IAS 2001: Interpretation and Application*. New York: John Wiley & Sons.

Challenges of Direct IAS Adoption

IAS offers a range of accounting policy choices to accommodate diverse views. For instance, whereas some countries adamantly support asset revaluation, others are fervently opposed (Appendix 2 identifies significant IAS benchmark and alternative treatments). While available choices have been significantly reduced since 1996, IAS is sometimes still criticized for being too flexible. For example, IAS 2 *Inventories* allows several valuation methods.

Most IAS adopters limit these alternative accounting policy choices to improve the consistency of national financial reporting. In many cases, accounting choices are restricted to those allowed for taxation purposes. In particular, depreciation rates are often mandated and Last-in First-out (LIFO) inventory valuations are disallowed.[37]

Moreover, where IAS does not address country-specific issues, there is a case for promulgating a national accounting standard. For instance, Papua New Guinea uses IAS directly but has released a national accounting standard on plantation accounting.[38] Likewise, Indonesia has an accounting standard on Shariah (Islamic) banking. Many other direct IAS adopters have national accounting standards on value added tax.

IAS Copyright and Pricing

For DMCs to effectively implement IAS-compliant accounting standards, accountancy teachers and academics, accountants, investors, lenders and regulators must have affordable access to standards and associated explanatory and training materials.

The IASCF holds copyright for IAS, IAS-Exposure Drafts (EDs) and other IASB publications in all countries and all languages, but does negotiate usage agreements (for example, payments for its license to use IAS comprise a significant proportion of the Fiji Institute of Accountants' outgoings). As of July 2002, while discounts of 50 percent were available to residents from developing countries, IAS materials remain expensive (see Table 3). For instance, the full set of Philippine accounting standards is available from Manila bookstores for P295 ($6.00).

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37 The *Improvements Project* is likely to remove the LIFO option from IAS 2.

38 The plantation accounting standard was originally developed in Sri Lanka. IASB has since issued IAS 41 *Agriculture*.

In contrast, International Education Standards (IESs), International Education Guidelines (IEGs) and International Public Sector Accounting Standards (IPSASs) are freely available from the International Federation of Accountants (IFAC) web site.[39] Furthermore—in an effort to improve access to auditing standards—IFAC has agreed that all final IAASB pronouncements will be freely available from January 2003.

Table 3: Prices for IAS Materials[40]

Publication	List Price	With Developing Country Discount (50 percent)
2002 International Accounting Standards Bound Volume (printed)	$74 (£120)	$74 (not applicable)
2002 International Accounting Standards Bound Volume (CD-ROM)	$188 (£120)	$94
Individual IASs	$24 (£15)	$12
Training Materials on IAS 7 *Cash Flow Statements*	$78 (£50)	$36

4. Financial Reporting for Smaller Enterprises (SMEs)

Introduction

In many DMCs, SMEs must comply with IAS-based accounting standards. However, IAS is intended for financial reporting by publicly listed companies; SMEs may lack the capacity to correctly apply the provisions of certain IAS accounting and disclosure requirements.

For example, IAS 19 *Employee Benefits* requires regular actuarial valuations of certain employee benefits for financial disclosure purposes. These valuations must be conducted whether the reporting organization is listed on the Hong Kong Stock Exchange or is an unlisted Fijian manufacturing enterprise.

Disclosure benefits are greatest where many external users depend on general-purpose financial reports for company information. But, because SMEs are usually not listed on stock exchanges, public interest is limited. Moreover, although SME shareholders may be separate from management, shareholdings are generally closely held. In most cases, the main external users of SME financial statements are special purpose users (e.g., lenders and taxation authorities). As these organizations can obtain financial

[39] www.ifac.org

[40] Source: www.iasc.co.uk (accessed on 28 July 2002).

information directly, it can be argued that the benefits of SMEs providing a full set of financial reporting disclosures are limited.

The issue of whether SMEs should comply with a full set of financial reporting disclosures is not limited to DMCs. A number of developed countries including Canada, New Zealand, the United Kingdom and the US have formalized full or partial exemptions from accounting standards for certain entities, usually smaller or closely-held entities (often called *differential reporting*).[41]

Given shortcomings in professional and regulatory frameworks, and shortages of suitably qualified and experienced accountants and auditors, SMEs in DMCs often face more difficulties than those in developed countries when applying IAS. Two initiatives to alleviate these problems are discussed next.

UNCTAD ISAR Framework for SME Accounting and Reporting

In July 2000, the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR), under United Nations Conference on Trade and Development auspices, established an *ad hoc* Consultative Group of Experts on Accounting by SMEs (SME-CG) to recommend an SME financial accounting and reporting framework.

ISAR requires the specified framework to: (i) be simple, understandable and user-friendly; (ii) produce useful management information; (iii) be as standardized as possible; (iv) accommodate business growth and eventual full IAS adoption; (v) be reconcilable for tax purposes; and (vi) recognize the SME operating environment.

The 2001 SME-CG report considered: (i) SME classifications for accounting and reporting purposes; (ii) suitable accounting and reporting frameworks for these SME classifications; (iii) possible implementation difficulties; and (iv) associated SME education needs.[42] It proposed three classification tiers:

[41] See: Financial Accounting Standards Board (FASB). 1996. FASB Statement No. 126: Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities. FASB: Washington D.C.; Accounting Standards Board (ASB). 1997. Financial Reporting Standard for Smaller Entities (FRSSE): ASB: London; Institute of Chartered Accountants of New Zealand (ICANZ). 1997. Framework for Differential Reporting. ICANZ: Wellington, New Zealand; Canadian Accounting Standards Board. 2001 July. Exposure Draft: Differential Reporting.

[42] UNCTAD ISAR. 2001 July 16. Accounting by Small and Medium-Sized Enterprises: Report by the Ad Hoc Consultative Group of Experts on Accounting by Small and Medium-Sized Enterprises. Report No. TD/B/COM.2/ISAR/12.

- Level I *(Full IAS)*. Entities that issue public securities, banks and financial institutions, and entities in which there is a significant public interest would comply completely with IAS.
- Level II *(Abridged IAS)*. Larger SMEs would use an abridged IAS version that technician-level preparers could apply (Appendix 2 identifies the proposed components of the abridged IAS version).
- Level III *(Simple Accruals)*. Smaller entities and new entrants would apply a basic accruals system, supported by a simple chart of accounts and standard financial statement formats.

National regulators adopting the framework would decide on the exact Level I, Level II and Level III criteria. The SME-CG contends that the Level II rules will not only provide an achievable step on the path to full IAS-compliance, but would support the development of professional accounting technicians.

ISAR's September 2001 meeting agreed with the SME-CG report, but requested that the proposals be further refined. In particular, ISAR suggested that SME-CG expand the Level III guidance and provide additional rationale for the Level II structure (i.e., the inclusion of certain IASs). The SME-CG will present its revised proposals to ISAR's 19th session in late 2002. ISAR is cooperating with IASB to address this urgent issue.

IASB Initiatives on SME Accounting and Reporting

In April 1998, IASB added the *Accounting by Small and Medium Entities and in Emerging Economies* project to its agenda. Although no progress has been made to date and IASB has yet to determine further activity, IASB officials have participated as observers at the ISAR SME-CG meetings.

5. Auditing Standards and Practices

Introduction

In 2002, IAASB superseded the International Auditing Practices Committee (IAPC). IAASB is an independent standard-setting body under IFAC auspices. Its key pronouncements are ISAs and International Auditing Practice Statements (IAPSs)(see Appendix 4).

Recent US corporate accounting scandals have forced auditing standards and practices into the international limelight. The US has taken decisive action to improve financial reporting arrangements (see Box 3). Other countries have also reviewed their arrangements.[43]

This section uses an analytical framework[44] to examine mechanisms that strengthen audit quality in the area of auditor: (i) appointment and dismissal mechanisms; (ii) independence; (iii) reporting requirements; and (iv) liability. These mechanisms are considered with reference to Sri Lankan and Singaporean arrangements.[45]

Box 3: Stricter Rules for US Capital Markets

On 30 July 2002, the Public Company Accounting Reform and Investor Protection (Sarbanes-Oxley) Act 2002 was signed into US law. Among other things, the Act will bring about the following changes:

- The General Accounting Office will examine and report on the mandatory rotation of auditing firms by July 2003. Meanwhile, five-yearly mandatory audit partner rotation has been introduced.
- A Public Company Accounting Oversight Board will: (i) register public accounting firms; (ii) establish auditing and other standards; (iii) inspect public accounting firms; (iv) conduct investigations; and (v) impose sanctions on public accounting firms. Only two of the Board's five fulltime members may be certified public accountants (CPAs).
- Chief Executive Officers and Chief Financial Officers must certify that the financial statements fairly present, in all material respects, the issuer's operations and financial condition. Fines and imprisonment may be imposed for misstatements.
- Public accounting firms may no longer provide the following services to audit clients: (i) bookkeeping or accounting services; (ii) information systems design or implementation; (iii) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (iv) actuarial services; (v) internal audit; (vi) management functions or human resources; (vii) broker or dealer, investment adviser, or investment banking services; (viii) nonaudit related legal services and expert services; and (ix) any other service the Board determines impermissible.
- Audit committees must be established and must pre-approve the provision of any other nonaudit services (e.g., taxation advice).
- Annual reports must include internal control reports: (i) stating that management is responsible for establishing and maintaining adequate internal control systems; and (ii) assessing the effectiveness of internal control systems. Auditors must attest to, and report on, management's internal control assessment.

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[43] See, for example:
Hong Kong Exchanges and Clearing Limited (HKE). 2002 January. *Consultation Paper on Proposed Amendments to the Listing Rules Relating to Corporate Governance Issues*. HKE Limited.
Ramsay, Ian. 2001 October. *Review of Current Australian Requirements and Proposals for Reform: Report to the Minister for Financial Services and Regulation*.

[44] Favere-Marchesi, Michael. 2000. Audit Quality in ASEAN. *The International Journal of Accounting*. Vol 35(1). pp. 121-149.

[45] Narayan, Francis B., Sarath Lakshman Athukorala and Barry Reid. 2002. *A Diagnostic Study of Accounting and Auditing Practices in Sri Lanka*. Manila: ADB. pp. 29-35.

Auditor Appointment and Termination

Mechanisms for appointing and dismissing auditors can enhance audit quality when they: (i) distance auditors from management—involving shareholders in the appointment and dismissal process strengthens auditor independence; (ii) match auditor skills to the audit assignment—for instance, only auditors with suitable financial sector experience should audit banks; (iii) ensure that incoming auditors are fully briefed on potential issues; (iv) protect auditors from financial coercion—for example, management may influence auditors who are given the alternative of dismissal without compensation (see Box 4); and (v) allow auditors to defend their position when dismissed.

Box 4: Sacking of Auditors in China a Worrying Trend[46]

The Chinese Institute of Certified Public Accountants (CICPA) has expressed concerns over several cases of 'malignant sacking' of auditors who failed to issue an opinion over the fairness and completeness of the financial statements and their notes to the accounts. CICPA also reiterated that it wants to make sure that unreasonable client demands won't [pass] by switching auditors.

Tianjin Xinde Certified Accountants, one of the largest audit firms in Shenzhen, was sacked by its long-standing client, Tonmac International, a machine-tool company over disagreements concerning financial statements last year and declining to give an opinion on the accounts. The audit firm also complained that client sales for the years 2001 and 2002 were overstated and the company used the money raised from issuing new shares last year in security trading and asset management, which violated the issue prospectus. Zhongtian Huazheng CPA suffered the same fate when it failed to see eye-to-eye with one of its clients, Shenzhen-listed Neimengu Hongfeng Industry.

Sri Lankan and Singaporean mechanisms compare well with these criteria. In particular, the Singaporean mechanism for compensation on termination is noteworthy (see Table 4).

Table 4: Auditor Appointment and Dismissal

Factor	Sri Lanka	Singapore
Nominating party	Shareholders (see below for bank auditor nominations)	Shareholders
Appointing party	Shareholders	Shareholders

46 *South China Morning Post*. 2002. Sacking of Auditors in China a Worrying Trend. 17 July.

Table 4: Auditor Appointment and Dismissal *(continued)*

Factor	Sri Lanka	Singapore
Party approving appointment	Bank audits are conducted by approved audit firms	Shareholders and the Monetary Authority of Singapore for financial institutions
Communication between outgoing and incoming auditors	Required by the Code of Conduct and Ethics, before an engagement is accepted	Required before engagement is accepted
Auditors rights to defend position on dismissal or resignation	Written or personal representation to shareholders	Written or personal representation to shareholders, filed with the Registrar of Companies
Compensation on termination	No, other than by the usual commercial practices	Fees owing to outgoing auditor must be paid before incoming auditor can accept the engagement

Auditor Independence

Auditor independence is absolutely fundamental to audit quality. However, potential mechanisms for ensuring independence—such as compulsory auditor rotation and restrictions on nonaudit services—are the ongoing subject of intense debate. The authors take the position that, while evidence regarding the effectiveness of some of these mechanisms may not be clear cut; their adoption has a lot of potential upside and minimal downside.

Whatever the case, mechanisms to enhance auditor independence include: (i) ensuring auditors are free of any interest that might be regarded as incompatible with integrity, objectivity and independence[47] —this includes limiting financial, personal or commercial relationships; (ii) placing limits on the nonaudit services that auditing firms provide to audit clients—one article reports that, for a sample of 307 listed US firms, fees paid for nonaudit services were almost three times the amount paid for audit fees[48]; (iii) requiring regular rotation of audit partners or audit firms to support objectivity and independence; and (iv) establishing effective audit committees. Sri Lankan and Singaporean mechanisms generally compare well with these criteria (see Table 5).

[47] IFAC. 1996. *Code of Ethics for Professional Accountants*. New York: IFAC.

[48] Weil, J. and J. Tannenbaum. 2001. Big Companies Pay Audit Firms More for Other Services. *The Wall Street Journal*. 10 April. p. C1.

Table 5: Auditor Independence and Incompatible Activities

Factor	Sri Lanka	Singapore
Restrictions on relationships: personal commercial financial, or influential	Yes	Some restriction on financial relationships
Restrictions on services provided by audit firms to audit clients (other than the audit)	Auditors may not provide services that effectively make them company officers or servants	Auditors may not provide accounting, tax advice, consulting, financial and investment advice or corporate recovery services
Rules to avoid low balling	Yes. Incoming auditors are not allowed to accept fees lower than those of outgoing auditors, at least for the first year	Yes
Required rotation of audit partners	No (But, the Auditor General informally rotates the private auditors of public corporations on a four-yearly basis)	Every five years for listed companies
Safeguards to objectivity:		
• Challenges to objectivity disclosed	Yes (if significant)	Yes
• Quality reviews	Recently adopted (to be implemented)	Yes
• Internal quality reviews	Yes	No
• Potential threats to objectivity monitored by third party	No	Yes
• Audit committees required	No (but recommended by Colombo Stock Exchange and encouraged by ICASL Corporate Governance Guidelines)	Yes

Audit Reporting Requirements

Although mandated audit reporting requirements can increase audit quality, there is a risk—particularly in developing and transitional countries—that auditors are seen as 'bloodhounds' rather than 'watchdogs'. Assigning quasi-regulatory functions to auditors may limit their access to company information thereby impairing their ability to issue an opinion as to the fairness of company financial statements. Table 6 indicates that Sri Lankan and Singaporean audit reporting requirements stray into quasi-regulatory territory.

Table 6: Audit Reporting

Issue	Sri Lanka	Singapore
In Auditor's Report:		
• Fraud or irregularities	Yes	Yes
• Illegal acts	Yes	Yes
• Internal controls and systems	Yes	Yes
• Maintenance of proper records	Yes	Yes
Reporting to Other Parties:		
• Fraud or irregularities	Yes	Yes
• Illegal acts	Yes	Yes
• Internal controls and systems	No	No
• Maintenance of proper records	Yes	Yes
Standard forms of audit reports required by law	Yes	Yes
Matters to be included in reports specified by law	Yes	Yes
Standard forms of audit reports established by professional bodies	Yes	Yes
Qualified audit reports due to uncertainties	Yes	Yes

Auditor Liability

Exposing auditors to civil liability creates strong incentives to raise quality and maintain independence.

> "A two-pronged approach may be adopted to encourage small shareholders to actively monitor their management. One is to require transparency and disclosures ... The other is to install provisions in the company laws to facilitate class action suits against corporate directors, management and external auditors. In a class action suit, all minority shareholders potentially benefit from the fruits of activism by a few shareholders. The threat of such action can be a powerful deterrent to management decisions that could result in the expropriation of wealth of minority shareholders."[49]

Nevertheless, there must be a balance between providing this incentive and avoiding a decline in audit services due to excessive litigation costs.[50] However, in developing and transition economies—particularly those with weak judicial systems—the possibility of civil litigation against auditors may not be a credible threat. Alternatively, regulated quality assurance reviews and sanctions may be more effective in encouraging better audit

[49] Zhuang, Juzhong, David Edwards, David Webb and Ma. Virginita Capulong. 2000. *Corporate Governance and Finance in East Asia: A Study of Indonesia, Republic of Korea, Malaysia, Philippines and Thailand*. Manila: ADB. p. 79.

[50] Palmrose, Zoe-Vonna. 1988. An Analysis of Auditor Litigation and Audit Service Quality. *The Accounting Review*. (63). pp. 55-73.

quality. Sri Lankan and Singaporean arrangements generally compare well (see Table 7).

Table 7: Auditor Liability

Issue	Sri Lanka	Singapore
Professional Sanctions:		
• Warning	Yes	Yes
• Reprimand	Yes	Yes
• Fine	Yes	Yes
• Temporary suspension	Yes	Yes
• Permanent exclusion	Yes	Yes
Legal liability cap between contract parties	No	No
Contractual liability cap between contract parties	No	No
Legal liability caps between contract parties and third parties	No	No

6. The Accountancy Profession

Introduction

If ADB DMCs are to effectively apply IAS, they require financial statement preparers and auditors who can exercise significant professional judgment.

Among other things, financial statement preparers and auditors must have a good understanding of accounting theory and be fully conversant with the IAS conceptual framework. Furthermore, they must keep abreast of changes to accounting and auditing standards through ongoing continuing professional education (CPE). This generally relies on the presence of strong professional bodies.

Moreover, the absence of suitable qualified and experienced accountancy professionals retards economic growth, impedes the effective implementation of donor-supported programs, and increases the severity and duration of asset and equity crises (see Chapter II).

Factors Affecting Development of the Accountancy Profession

Some economies have a better professional infrastructure than others because of their legal traditions. Former British colonies (e.g., Canada and Malaysia) use common law systems and rely on independent judges and juries and legal principles supplemented by precedent-setting case law to respond to evolving circumstances. Civil law countries (e.g., Indonesia and the Republic of Korea) rely on legal codes that contain very specific rules and are less adept at responding to changing environmental needs. Indeed, legal traditions affect the development of professions to a remarkable degree—researchers have found a robust negative correlation between the civil law tradition and lack of professions, on the one hand, and a supporting and beneficial impact of professions on the rule of law, on the other.[51]

Relevant Professional Standards and Guidance

In 1998, to assist member countries develop strong and ethical accountancy professions, the Confederation of Asian and Pacific Accountants (CAPA) issued the *Guide on the Essential Components of a Professional Accountancy Body*.

The *Guide* identifies 10 components of a professional accounting body including admission standards, membership requirements, CPE, technical standards, quality assurance processes and disciplinary rules. Appendix 5 describes other relevant materials.

IFAC Education Standards and Guidelines

The IFAC Education Committee is reviewing IESs and IEGs (see Appendix 6). The Committee has already released EDs on *Competence-Based Approaches to the Preparation and Work of the Professional Accountant*[52] and *Guiding Principles for International Education Statements.*[53] The discussion paper on competence-based approaches explores accountant competency and examines various country approaches. It defines competencies and capabilities, provides guidance on developing competence and assesses country approaches.

The IFAC Financial and Management Accounting Committee (FMAC) study on *Competency Profiles for Management Accounting Practice and Practitioners* highlights the competencies related to best management accounting practices. It also discusses competency standards and related assessment methodologies.[54]

IFAC Public Sector Committee (PSC) Study No. 14 *Transition to the Accrual Basis of Accounting: Guidance for Governments and Government Entities* discusses issues associated with the identification, design and delivery of

51 La Porta, Rafael, Florencio López-de-Silanes, Andrei Shleifer and Robert W. Vishny. 1998. Law and Finance. *Journal of Political Economy*. Vol. 106(6). pp. 1113-1155.

52 IFAC. 2001 May. *Competence-Based Approaches to the Preparation and Work of the Professional Accountant*. New York: IFAC Education Committee.

53 IFAC. 2002 June. *Guiding Principles for International Education Statements*. New York: IFAC Education Committee.

54 IFAC. 2002 June. *Competency Profiles for Management Accounting Practice and Practitioners.* New York: IFAC Financial and Management Accounting Committee (FMAC).

training to support the adoption of accrual accounting. Although developed to assist public sector entities moving to accrual accounting, this guidance may be useful in other contexts.[55]

UNCTAD Initiatives

A 1999 UNCTAD report considered accountancy education and qualifications.[56] It provides a useful set of benchmarks, in particular:

- *Guideline for a Global Accounting Curriculum and Other Qualification Requirements* (Includes the requirements for the qualifications of professional accountants, and the guideline for national systems for the qualifications of professional accountants); and
- *Global Curriculum for the Professional Education of Professional Accountants* (Includes organizational and business knowledge; information technology; and accounting and accounting-related knowledge).

Establishing a global curriculum will: (i) provide a benchmark for mutual recognition; (ii) enable employers and educators to compare qualifications of foreign students; (iii) support the free flow of professionals across borders; and (iv) support the work of the World Trade Organization (WTO) to implement the General Agreement of Trade and Services (GATS).

Another UNCTAD project will assess the competence of accountants. Its objective is to rate professional accounting qualifications from around the world and, in doing so, create impetus for improvements and support international skill transferability.

7. Public Sector Reporting

Introduction

Most countries are adopting IAS for private sector financial reporting. Meanwhile, the financial reports of public sector organizations vary significantly across the world—most countries require businesses to prepare and publish balance sheets—few require this basic discipline of public sector organizations.

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[55] IFAC. 2002 May. *Transition to the Accrual Basis of Accounting: Guidance for Governments and Government Entities*. PSC Study No. 14. New York: IFAC Public Sector Committee (PSC).

[56] UNCTAD. 1999. *International Accounting and Reporting Issues: 1999 Review*. New York: United Nations.

There are compelling arguments in favor of accrual-based budgeting and reporting for governments. A number of developed countries including Australia, Canada, Iceland, Italy, New Zealand and the US have adopted accrual-based financial reporting.

Box 5: Accrual Accounting in the United Kingdom

The United Kingdom has adopted accrual accounting at the agency level and is looking to produce aggregate consolidated financial statements for 2006. It plans to prepare consolidated financial statements in a staged manner:

- Stage 1 will involve consolidating the unaudited central government accounts using 2001-02 National Accounts information.
- Stage 2 will involve consolidating accrual 2003-04 central government accounts.
- Stage 3 will involve a whole-of-government accounts consolidation for 2005-06.

Likewise, some ADB DMCs are considering, or are in the process of, moving to the accrual accounting basis (see Table 8). This study recognizes the benefits of the accrual accounting basis, but urges caution in its adoption. For instance, we recommend that RMI defer its move to accrual accounting (even though this conflicts with US accounting standards). This recommendation is based on the absence of formally-qualified accountants in the RMI government. Moreover, it should be stressed that the developed countries that adopted accrual reporting did so over a period of years (e.g., Canada took several years and New Zealand took three).

IFAC Public Sector Committee (PSC)

The IFAC PSC promulgates International Public Sector Accounting Standards (IPSAS) and other guidance for public sector entities. As of June 2002, PSC had issued 18 IPSASs (see Appendix 7). It also publishes guidance materials and studies (see Appendix 8).

Table 8: Eleven Selected ADB DMCs: Accounting Status

Country	Description
Azerbaijan	Accrual-based Soviet Accounting System. Agencies prepare balance sheets, but aggregate government financial statements are cash-based. The IMF and the World Bank are encouraging the implementation of cash-based accounting.
Fiji Islands	Uses cash-based accounting, but has recently purchased an accrual-based computer system (SAP) and intends to move to accrual accounting in the next few years.
Indonesia	Uses cash-based accounting. The State Accounting Office plans to introduce accrual accounting.

Table 8: Eleven Selected ADB DMCs: Accounting Status *(continued)*

Country	Description
Mongolia	Accrual-based Soviet Accounting System. Agencies currently prepare balance sheets, but aggregate government financial statements are cash-based.
Pakistan	Uses cash-based accounting, but is implementing accrual-based accounting.
Papua New Guinea	Uses cash-based accounting, but is implementing accrual-based accounting.
People's Republic of China	Accrual-based Soviet Accounting System. Agencies currently prepare balance sheets, but aggregate government financial statements are cash-based. Agency accounting is a mixture of cash and accrual—the adoption of full accrual accounting is planned.
Philippines	Uses cash-based accounting. Government has announced its intention to introduce accrual budgeting and accounting. Groundwork has commenced.
Republic of the Marshall Islands (RMI)	Uses cash-based accounting. RMI follows US government accounting practices and is legally required to adopt accrual accounting in 2002.
Sri Lanka	Uses cash-based accounting, but intends to move to the accrual accounting basis over time.
Uzbekistan	Accrual-based Soviet Accounting System. Agencies prepare balance sheets and aggregate government financial statements are cash-based. Accounting standards are sector-neutral (i.e., the same IAS-based accounting standards apply equally to the public and private sector).

In May 2000, PSC issued ED 9 *Financial Reporting under the Cash Basis of Accounting*. ED 9 proposes requirements for the preparation and presentation of cash flow statements under the cash accounting basis. It included requirements relating to the definition of the reporting entity and the structure and content of the cash flow statement. PSC is currently considering its response to comments received on ED 9 and has indicated that it intends to allow greater flexibility in the presentation format adopted.

Other recent PSC documents include Study 14 *Transition to the Accrual Basis of Accounting: Guidance for Governments and Government Entities* (see Box 6) and occasional papers on the modernization of government accounting in France and the United Kingdom.

In response to donor community requests, PSC is considering developing an IPSAS on development assistance, which could replace many existing special-purpose reporting requirements, thereby reducing DMC compliance costs.

Box 6: PSC Study No. 14: Transition to the Accrual Basis of Accounting: Guidance for Governments and Government Entities[57]

This Study provides practical guidance to assist governments move to the accrual accounting basis in accordance with accrual-based IPSASs. Study 14:

- identifies key issues to be addressed
- identifies alternate implementation approaches
- identifies the main tasks associated with recognizing assets, liabilities, revenues and expenses
- highlights implications of implementing certain IPSASs; and
- provides practical suggestions based on the experience of other entities and jurisdictions.

SNA and GFS and IPSAS

This section briefly outlines the relationship between national accounts prepared in accordance with the UN System of National Accounts (SNA), IMF Government Finance Statistics (GFS) and IPSAS. SNA and GFS are based on the same principles, but have different objectives and involve different reporting entities:

- SNA compiles aggregate financial statistics for an entire economy; government and private sector activities are combined together.
- GFS is a specialized system intended to support public sector analysis. The IMF designed GFS so that government financial information could be compared across economies.[58]
- IPSAS is designed for use in the preparation of general-purpose financial reports by public sector entities (individual government agencies or whole-of-government reports). Entities applying the accrual-based IPSASs must also prepare cash flow statements in accordance with IPSAS 2 *Cashflow Statements*.

SNA, GFS and IPSAS are all accrual-based systems, but there are three key differences. First, as already described, the reporting entity may differ. Second, classification and measurement differences exist. For example, SNA classifies some military assets as capital expenditure (assets) and some as current expenditure (expenses). Conversely, IPSAS 17 *Property, Plant and Equipment* requires that all military equipment meeting the definition of

57 IFAC. 2002 May. *Transition to the Accrual Basis of Accounting: Guidance for Governments and Government Entities.* PSC Study No. 14. New York: IFAC Public Sector Committee (PSC).

58 IMF. 2001. *Government Finance Statistics Manual 2001.* Washington DC: IMF. URL: www.imf.org

property plant and equipment and asset recognition criteria be capitalized. Third, the three systems vary in focus. For instance, GFS highlights changes in opening and closing net worth.

8. Conclusion

The issues reviewed in this chapter are relevant to the five participating countries and to ADB DMCs more generally. In particular, country auditing practices are currently under intense scrutiny. This chapter reviewed mechanisms that potentially strengthen audit quality. Moreover, this chapter provides background context for the following chapters that examine individual country accounting and auditing practices.