

REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)
Republic of Kazakhstan

ACCOUNTING AND AUDITING

May, 2007

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Executive Summary

This report provides an assessment of accounting, financial reporting, and auditing requirements and practices within the enterprise and financial sectors in Kazakhstan. The report uses International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA), and draws on international experience and good practices in the field of accounting and audit regulation, including in European Union (EU) Member States, to assess the framework for financial reporting and to make policy recommendations.

The policy recommendations aim to help the Kazakhstan Government to support the country's integration into the global economy, in particular through strengthening the corporate sector's accounting, financial reporting and auditing practices., Establishing Kazakhstan as one of the 50 most competitive economies in the world through integration into the global economy was named as the top priority for the country's economic development by the President of Kazakhstan in his address to the nation on March 1, 2006. A key component of developing this competitiveness is the existence of high quality financial information for Kazakhstan companies that foreign partners can easily understand and trust; this information should be readily available, and should be prepared and audited in accordance with international standards.

Kazakhstan has a population of 15.2 million and gross domestic product (GDP) per capita of US\$ 5,100 as of 2006. Real GDP growth since 2000 has averaged 9 percent per year, driven in large part by foreign investment in the oil sector. In fact, Kazakhstan has been quite successful in attracting foreign direct investment (FDI) with cumulative inflows at the end of 2004 amounting to US\$21.8 billion, the highest in the Commonwealth of Independent States (CIS). However, portfolio investment in Kazakhstan remains small, with Kazakhstan's Eurobonds accounting for most of the country's total external portfolio investment.

The financial sector, which is dominated by private commercial banks, has been one of the fastest growing sectors in Kazakhstan. However, while lending to the private sector has increased to US\$13 billion in 2004 (almost 33 percent of GDP), credit risk analysis remains underdeveloped

This report was prepared by a team from the World Bank on the basis of the findings from a diagnostic review carried out in Kazakhstan in November 2005. The staff team was led by Frédéric Gielen (ECSPS) and comprised David Cairns (Visiting Professor, London School of Economics), Ishan Delikanli (Banking and Regulation Supervision Agency, Turkey), Gert Karreman (Former Director of Education, NIVRA), Aliya Kim (ECSPS), Galina Kuznetsova (ECSPS), and Ian Ritchie (Director of the Center for International Corporate Governance and Accounting at the University of Paisley). The review was conducted through a participatory process involving various stakeholders and led by the country authorities.

and there are problems with assessing the underlying portfolios due to a significant lack of transparency regarding related parties and ultimate economic beneficiaries.

The role of the non-banking financial sector is still limited but growing. Kazakhstan introduced a mandatory private pension regime with individual accounts. As a result, in 2004 there were 16 approved pension funds managing assets worth a total of approximately US\$3.7 billion or 8.7 percent of GDP. The insurance sector is still small with insurance premiums representing about 0.7 percent of GDP. The continually growing assets of the accumulative pension funds have had a positive impact on the development of the corporate bond market in Kazakhstan. The equity market is still relatively small, but growing rapidly. The total market capitalization of securities included in the Kazakh Stock Exchange (KASE) official listings at the end of 2004 amounted to US\$9.2 billion, an increase of over 68 percent compared to 2003.

Kazakhstan was among the first CIS countries to promulgate accounting standards, initially setting a policy in 1995 of developing National Accounting Standards “based on” International Accounting Standards; the first of these were adopted in 1996. In 2002, the standard setting body took a bold step when it decided to adopt IFRS in its entirety for certain companies, commencing on defined dates. Furthermore, Kazakhstan was one of the first CIS countries to adopt a law on audit activities, which established the concept of auditing standards. As a result, accounting and auditing is more advanced in Kazakhstan than in most other CIS countries. However, as this report shows, much remains to be done if Kazakhstan wishes to raise the quality of accounting and auditing practices to a level in line with more-developed economies.

Accounting and Audit Reform in Kazakhstan

Accounting in Kazakhstan is generally governed by the provisions of the Law on Accounting and Financial Reporting of 1995 (the “Accounting Law,”), which has recently been amended. Prior to the recent amendments, according to this Law, IFRS was required to be used in the preparation of financial statements by financial institutions from January 1, 2003, by joint-stock companies from January 1, 2005 and by all other entities (excluding state-financed entities) from January 1, 2006. Before these dates, all the entities were required to apply Kazakh Accounting Standards (KAS) as approved by the relevant government organization.

The Accounting Law has just been amended; the amendments were enacted by the Parliament on February 28, 2007. The amendments introduced a three-tiered reporting structure. Under this structure, micro-enterprises would continue to apply simplified tax-based rules; small and medium-sized enterprises (SMEs) would be required to apply KAS; and public interest entities (PIEs) and large companies would be required to apply IFRS. The term ‘public interest entities’ would be defined to include joint stock companies (excluding non-for profit organizations), financial institutions, companies with state participation and certain extractive industry companies. Such an approach would address the problem of applying IFRS in organizations for which IFRS was not designed or intended.

There are specific accounting requirements for banks, insurance companies and some listed companies:

- Banks are required to comply with IFRS. Banks with subsidiaries are obliged to prepare consolidated financial statements. Banks are required to publish audited legal entity financial statements, however, they are not required to publish consolidated financial statements. As a result, depositors and other creditors may face considerable difficulty in getting sufficient information about banks’ complete financial condition.

- Insurance companies are required to prepare financial statements in compliance with IFRS and are required to publish audited balance sheet and income statements.
- Companies listed on the highest listing category of KASE (Category A) are currently required to prepare their financial statements in accordance with IFRS. Companies listed on the lower listing category (Category B) may prepare financial statements in accordance with either IFRS or KAS, if the latter does not contradict legislation. The KASE discloses the information it receives from listed companies on its website, but little detailed checking of the information received is performed. Thus, the financial statements of listed companies are often incomplete and of variable quality.

All other companies, including pension funds (which must be incorporated as a joint-stock company), are required to follow the Accounting Law and any other requirements specific to their company type, such as the Law on Joint-Stock Companies. According to this law, Joint-Stock Companies must publish audited financial statements in the mass media, with the exception of the audit report, which is not required to be published.

Although most public interest entities are required to publish certain parts of their legal entity financial statements in the Kazakh mass media, this requirement does not ensure that the financial statements can be readily located by the public, nor does it allow the public to access the full financial statements. Furthermore, access to, and availability of, consolidated financial statements is limited. The current version of the Accounting Law allows the Government to set up a depositary where all PIEs must file their financial statements.

Currently, there are some 27 KAS, the majority of which are “based on” an IFRS equivalent extant at the date the respective KAS was developed. Additionally, some KAS have no IFRS equivalent and some areas covered by IFRS are not covered by an equivalent KAS.

The significant revisions to the Audit Law enacted in May 2006 state that, from November 2006, audits are to be carried out in compliance with International Standards on Auditing (ISA), if the standards do not contradict national legislation. The ISA must be published in the Kazakh and Russian languages by an organization in receipt of written permission from IFAC’s International Auditing and Assurance Standards Board (IAASB) to prepare an official Kazakh translation.

The previous Audit Law required application of Kazakh Standards on Auditing (KSA), which fell short of full (and current) ISA. Under the previous audit regime there was a great deal of confusion among auditors with regard to which standards should be applied: the 11 KSA then approved by the Ministry of Finance only, the full set of 48 KSA issued by the Kazakh Chamber of Auditors (COA), or full current ISA. Thus there is a significant risk that the majority of local auditors are not familiar with full current ISA and will struggle with the proper implementation of the new Audit Law in the near future.

The Accounting and Audit Profession

The Kazakh accounting and audit profession suffers from a number of weaknesses, which results in a chronic lack of qualified professionals. These weaknesses are rooted in a lack of adequately-trained instructors to deliver academic (i.e., at the university and post-graduate level), professional, and continuing professional development (CPD) courses. This is exacerbated by the fact that practical experience requirements do not comply with international standards, and are not adequately enforced. Further, the availability of CPD and other training is not sufficient.

Important steps are introduced by the new Audit Law, which requires obligatory quality control to be exercised by professional associations in respect of their members. All auditors must be a member of only one professional association at a time. Quality control is to be carried out once every three years. The procedures of quality control inspections are to be determined by the professional associations. The inability of an auditor to pass the quality control procedure will lead to the temporary withdrawal of the audit license. However, there is no provision in the law on making the results of quality control inspections public. The Audit Law refers to these responsibilities of 'professional organizations'; at present there are two such professional organization in Kazakhstan, the Chamber of Auditors (COA) and the Collegium of Auditors (CoIOA).

In addition to the COA and the CoIOA, which are for auditors, there are currently professional organizations for accountants, such as the Chamber of Professional Accountants and Auditors (CPAA) and the Union of Accountants and Auditors of Kazakhstan. The COA is a full member of the International Federation of Accountants (IFAC); however, it does not yet comply with all IFAC Statements of Membership Obligation (SMOs). Both the COA and CPAA are members of the Eurasian Council of Certified Accountants and Auditors.

In addition to adopting auditing standards, the COA is also responsible for professional education of its members. The COA has developed a Code of Ethics based on the 1998 IFAC Code of Ethics. However, the COA Code falls short of current IFAC requirements, which have been significantly enhanced, especially where they relate to auditor independence. In addition, the ROSC team noted several instances where the existing Code was not being complied with.

In order to become a COA auditor, an individual must be certified by the Qualification Commission (QC) of the COA, which bases their examinations on the CAP/CIPA program. The QC examination is carried out under strict regulations, guaranteeing a fair process. However, pass rates are low due to low levels of preparedness by candidates, ineffective training provision and high examination standards.

CPAA comprises mostly Certified Accounting Practitioners (CAP, or certified accountants), with only a few Certified International Professional Accountants (CIPA, or certified auditors). The CPAA has issued professional rules for its members; however, the ROSC team found that individual members were largely unaware of the existence of the rules.

There is a significant problem in the certification of accountants and auditors in Kazakhstan, in that CPAA-certified accountants are not able to leverage their qualifications (as a CAP or CIPA) to become a COA-certified auditor, even though both the CPAA and COA certification processes are based on the same CAP/CIPA program. This means that a CPAA certified accountant would need to sit the entire QC examination, just as any other person with no accounting qualification or experience.

There is currently no requirement for the rotation of audit firms of banks or insurance companies, but there is a proposal to amend the Law on Insurance Activities, which would require auditor rotation every three years.

Monitoring and Enforcement

The Agency for Financial Supervision (AFS) is responsible for the supervision and regulation of all regulated markets: the banking sector, the insurance sector, the securities market and pension funds. Effective supervision by the AFS is hampered by a lack of qualified staff, particularly staff

trained in IFRS, which makes the specific task of monitoring compliance with IFRS problematic. Furthermore, while the AFS is endowed with the necessary legal authority to supervise regulated companies, enforcement measures are neither effective nor timely:

- **Banking sector:** In practice, the AFS does not effectively monitor compliance with accounting, reporting, and auditing requirements in the general purpose financial statements of banks. This is due in part to the fact that AFS supervisors do not rely on audited financial statements for their supervisory activities. Instead, they rely on examination of prudential reports and their own investigations. Thus, although numerous sanctions for non-compliance with reporting requirements are set forth in the Banking Law and the Administrative Violations Code, the ROSC team could not find a single instance where the sanctions described have been exercised by the AFS.
- **Insurance sector:** On the insurance side, however, the AFS seems to be making a more diligent effort in ensuring compliance with financial reporting rules and has issued a number of injunctions to insurance companies regarding the submission of unreliable reports.
- **Listed companies:** Monitoring compliance with financial reporting rules does not seem to be a priority for the AFS or the KASE. Currently there appears to be little monitoring of the content of published financial statements (e.g., compliance with financial reporting standards), but rather, emphasis is placed on administrative issues such as late filing. The result is that, in some cases, the information that is available to investors may not adequately represent the financial condition of a company, and could thus be misleading.

Accounting Standards Gaps Analysis

While there is a generalized belief that IFRS and Kazakh accounting requirements (for the enterprise and financial sectors) are broadly aligned, some differences remain. There are differences between the accounting policies used and disclosures made under KAS and those which would be required under IFRS. This suggests that the differences between KAS and IFRS are greater than claimed. A number of key systemic issues were identified including:

- Valuation of property, plant and equipment tend to be overstated, due to a lack of impairment tests and to periodic revaluations, which were required by authorities during hyperinflationary times.
- Interest-free loans, which are frequent in the enterprise sector, tend to be overstated on the balance sheet of the lender.
- Defined-benefit pension plans tend not to be properly accounted for, which understates liabilities.
- There is a tendency to use a formulaic approach in measuring the costs of agricultural products and livestock, which may distort the allocation of resources to the agricultural sector.

Compliance Gap Analysis (IFRS and KAS compliance)

The ROSC team conducted a compliance gap analysis, which showed that the quality of the financial statements prepared by the majority of enterprises in practice falls far short of the standard implied in the reporting requirements embodied in statutory framework.

Audited IFRS financial statements generally appeared to comply with IFRS, but a number of significant non-compliance issues were noted, leading the ROSC team to question the capacity of preparers and auditors. In addition, regulatory bodies lack the resources to effectively control preparation of financial reports in accordance with IFRS.

The quality of KAS-based financial statements was generally very weak, and the ROSC team noted widespread non-compliance issues. These issues were so significant that, in most instances, users of these financial statements would be unable to make an informed decision on their basis or, worse, could be misled in their decision-making. This could generally be attributed to the lack of capacity to comply and enforce KAS on the part of preparers, auditors and regulators.

Auditing Standard and Compliance Gaps Analysis

As mentioned previously, the new Audit Law requires the use of ISA starting from November 2006. Previously, Kazakh Standards of Auditing (KSA) were used. KSA fall significantly short of ISA for two main reasons: KSA are based on outdated versions of ISA, and KSA are incomplete, with only eleven approved standards, as compared to over 30 standards which comprise ISA. Thus, the differences between KSA and ISA are such that an audit performed in accordance with KSA is likely to provide significantly less assurance than an audit performed in accordance with ISA.

The resulting quality of statutory audit, as observed by the ROSC team, was very uneven. Local member firms of international audit firm networks appear to use more in-depth audit procedures and assign more experienced personnel when auditing IFRS financial statements than when auditing KAS-based financial statements. Similarly, audits of IFRS financial statements of companies raising debt or equity financing abroad tended to be of higher quality.

While some local audit firms make great efforts to comply with international standards, a significant number of their audit reports were so poor as to preclude a user of these audited financial statements to reach any conclusion about the work undertaken by the audit firm. In addition, a number of audit reports prepared by local audit firms gave rise to significant concerns regarding compliance with the Code of Ethics, including independence. There are also significant concerns that the majority of local audit firms are not familiar with the full current ISA, which they will be required to follow in accordance with the revised Audit Law.

Main Recommendations

While all the policy recommendations set forth in Section VI of this report are important, the ROSC team has identified a number recommendations that it considers to be “critical success factors” because of their extreme importance for financial system stability, economic growth (including mobilization of investment capital) and the fight against corruption. These critical recommendations, which are explained below and sequenced in Figure 1, fall under the six major pillars of the accounting and auditing infrastructure, each of which plays a major role in shaping the overall accounting and auditing culture and environment:

- **Require public interest entities to adopt IFRS (short term):** IFRS represents a comprehensive, high-quality financial reporting framework that is internationally recognized

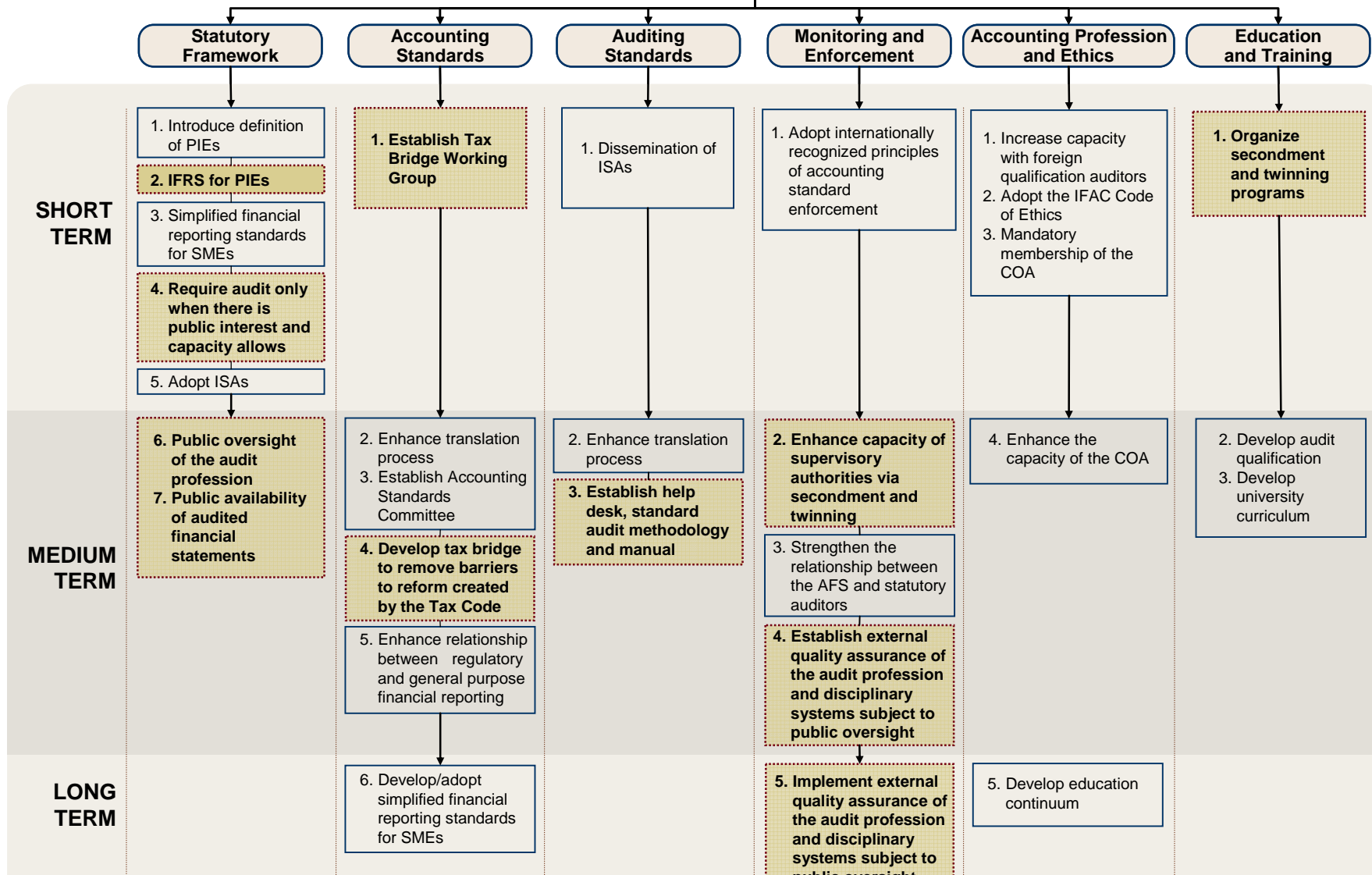
and promotes greater reliability and comparability of financial information. Because of their importance to the economy and to society, *public interest entities* should be required to prepare their financial statements in compliance with IFRS. Three criteria could be used to define such entities: (a) having securities listed; (b) the nature of the business (for example, banks and insurance companies); and (c) the size of the business (exceeds thresholds regarding total assets, annual sales or number of people employed). The recent amendments to the Accounting Law enacted in 2007 address this.

- **Require audits only when there is public interest and capacity allows (short term):** The number of entities subject to a statutory audit requirement should be commensurate with the number of available qualified auditors. Policymakers should phase in statutory audit requirements with a view to ensure that they do not crowd out Kazakhstan's audit capacity.
- **Establish and implement external quality assurance of the audit profession and disciplinary systems, subject to public oversight (medium to long term):** The recent amendments to the Audit Law require professional associations to implement quality control procedures but do not introduce public oversight of these schemes. The professional organizations should be supervised by a public oversight system consisting of a majority of non-practitioners to ensure that the audit profession does indeed serve the public interest. Such an oversight body would also be responsible for: (a) ensuring that the quality assurance system for the audit profession is, in fact and appearance, an exercise with sufficient public integrity and (b) promoting public confidence in the profession. Quality assurance for the audit profession is also fundamental for ensuring good audit quality, which adds credibility to published financial information and protects shareholders, investors, creditors and other stakeholders. The results of the external quality assurance system should feed into the Continuing Professional Development program and/or the disciplinary system, as appropriate. Successful implementation of quality assurance by the professional organizations is key to audit quality in Kazakhstan.
- **Require that audited financial statements be available to the public (medium term):** Requiring the public availability of the full set of financial statements, including notes, is important for several reasons. First, public availability of financial statements protects third parties (including creditors, suppliers, employees, etc.), as it reduces the asymmetry of information between firms and third parties. Second, it helps to protect the public from potential negative economic impact; this would be the relevant, for example, in the case of economically significant companies, where their actions and/or demise could have a significant negative impact on the local economy. Finally, it promotes improved allocative efficiency both within firms and in the economy, as managers and investors would be better able to distinguish between good and bad investment opportunities and business operations. The requirement in the proposed amendments to the Accounting Law for PIEs to file their financial statements with the public depository will increase the availability of financial statements to the public.
- **Develop a tax bridge to remove barriers to reform created by the Tax Code (short to medium term):** Kazakhstan will need to consider to what extent, if at all, the principle of tax following accounts is an appropriate policy objective in itself. The advantages are clarity and consistency of financial reporting (which we take to be the meaning of the over-used expression "transparency") and reduction of compliance burdens (i.e. enterprises not being obliged to produce separate sets of accounts for financial reporting and tax purposes). However, experience suggests that there is a great danger of treating these factors as sacrosanct and self-justifying. They can blind people to the fact that an accounting system and a tax system will each have their own set of priorities and basic principles, and those sets may well bear an uneasy relationship to one another, or even be incompatible. After

addressing the policy objective, the authorities may need to establish a tax reconciliation process addressing the potential problems arising in situations where some taxpayers use IFRS as the starting point for calculating taxable profit, and others use Kazakh Accounting Standards. This will include outlining how tax authorities ensure that the book-tax reconciliation process results in the same taxable profit, irrespective of whether the starting point is IFRS or national accounting standards.

- **Establish a help desk, standard audit methodology and audit manual for ISA (medium term):** If the above services could be offered by the COA, this would promote improvements to the profession's capacity overall, particularly for local audit firms. This, in turn, would promote healthy competition in the audit sector, with positive effects for the Kazakh economy.
- **Organize a secondment and twinning program with a view to enhance the capacity of supervisory authorities (short and medium term):** The supervisory agencies (AFS, NBK, Ministry of Finance, etc.) should second key operational staff to similar agencies abroad for "on the job training" on best international practices regarding monitoring and supervision in respective areas, as well as IFRS. The supervisory agencies should also enter into twinning programs to bring experienced regulators from peer institutions abroad to Kazakhstan to work with selected staff in the AFS, NBK, KASE, etc.

ACCOUNTING AND AUDITING ROSC POLICY RECOMMENDATIONS



MAIN ABBREVIATIONS AND ACRONYMS

AFS	Agency for Financial Supervision
CAP	Certified Accounting Practitioner
CESR	Committee of European Securities Regulators
CIPA	Certified International Professional Accountant
CIS	Commonwealth of Independent States
COA	Chamber of Auditors
CPAA	Chamber of Professional Accountants and Auditors
CPD	Continuing Professional Development
EDCOM	Education Committee of IFAC (now IAESB)
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IAESB	International Accounting Education Standards Board (formerly EDCOM)
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IASCF	International Accounting Standards Committee Foundation
IES	International Education Standard
IFAC	International Federation of Accountants
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IPO	Initial Public Offering
IPSAS	International Public Sector Accounting Standards
ISA	International Standards on Auditing
JERP	Joint Economic Research Program
KAS	Kazakh Accounting Standards
KASE	Kazakh Stock Exchange
KSA	Kazakh Standards on Auditing
NBK	National Bank of Kazakhstan
NIVRA	Royal Dutch Institute of Accountants
PIE	Public Interest Entity
PPE	Property Plant and Equipment
QC	Qualification Commission
ROSC	Reports on the Observance and Standards of Codes
SME	Small and Medium-sized Enterprise
SMO	Statement of Membership Obligation
SOE	State Owned Enterprise
USAID	United States Agency for International Development

I. INTRODUCTION

1. This assessment of accounting and auditing practices in Kazakhstan is part of a joint initiative of the World Bank and International Monetary Fund (IMF) to prepare Reports on the Observance of Standards and Codes (ROSC). The assessment focuses on the strengths and weaknesses of the accounting and auditing environment that influence the quality of corporate financial reporting and involves a review of both mandatory requirements and actual practice. It uses International Financial Reporting Standards (IFRS)¹ and International Standards on Auditing (ISA)² as benchmarks and draws on international experience and good practices in the field of accounting and auditing regulation.

2. The Government of Kazakhstan requested that the World Bank conduct this Accounting and Audit ROSC under the umbrella of the Kazakhstan-World Bank Joint Economic Research Program (JERP). JERP is a three-year program of joint economic research financed through a cost-sharing arrangement between the Government of Kazakhstan and the World Bank.

3. Kazakhstan has a population of 15.2 million and gross domestic product (GDP) per capita of US\$ 5,100 as of 2006.³ After the collapse of the Soviet Union, Kazakhstan experienced one of the worst economic contractions in the former Soviet bloc with real GDP falling by 35% between 1990 and 1995. The turnaround in economic performance in 1999 was a result of higher oil prices and better weather, which benefited the agricultural sector. Oil sector investment by foreign firms has helped to increase oil production and, as a result, real GDP growth since 2000 has averaged 9 percent per year. Average consumer price inflation has dropped from 13.4% in 2000 to 6.9 % in 2004.

4. Kazakhstan has attracted nearly 80 percent of all the foreign direct investment (FDI) into Central Asia with cumulative inflows at the end of 2004 amounting to US\$21.8 billion, the highest in the Commonwealth of Independent States (CIS). However, portfolio investment in Kazakhstan remains small with Kazakhstan's Eurobonds accounting for most of the country's total inward portfolio investment.

5. FDI has enabled the economy to recover but the inflows have been heavily concentrated in extractive industries, mainly oil, which accounted for some 64.5 percent of total investment flows. The importance of the oil and gas industry for the development of the Kazakhstan economy is paramount. Oil and gas exports accounted for some 57 percent of the country's exports. Other sectors remain weak compared to the oil sector with the agricultural sector, for example, now representing only 7.9 percent of GDP (down from 23 percent in 1992) though it remains the largest employer in the economy.

6. The quality of the banking sector has improved since 1995. There has been considerable consolidation in the sector from 130 banks in 1995 to 36 in June 2005. Lending to the private

¹ International Financial Reporting Standards are issued by the International Accounting Standards Board (IASB), an independent accounting standard-setter based in London, United Kingdom. The IASB announced in April 2001 that its accounting standards would be designated "International Financial Reporting Standards" (IFRS). Also in April 2001, the IASB announced that it would adopt all of the International Accounting Standards (IAS) issued by the International Accounting Standards Committee (IASC). For simplicity's sake the term IFRS will mean both IFRS and IAS in this report.

² International Standards on Auditing are the standards issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants (IFAC).

³ Gross domestic product based on purchasing-power-parity per capita, International Monetary Fund, World Economic Outlook Database, September 2005.

sector has increased to US\$13 billion in 2004 or nearly 33 percent of GDP. There is some concern over the deterioration of banks' loan portfolios as credit risk analysis is underdeveloped and there are problems with assessing the underlying portfolios due to a significant lack of transparency regarding related parties and ultimate economic beneficiaries. This calls for strengthened accounting practices, especially with respect to related party disclosures.

7. The role of the non-banking financial sector is still limited but is growing. Kazakhstan introduced a mandatory private pension regime designed to move the pension burden from the state directly to the individual citizen. There were 16 approved pension funds at the end of 2004 managing assets worth a total of approximately US\$3.7 billion or 8.7 percent of GDP. The insurance sector, comprising of 36 insurance companies, is still small with insurance premiums representing about 0.7 percent of GDP.

8. The continually growing assets of the pension funds have had a positive impact on the development of the corporate bond market in Kazakhstan. The Kazakh Stock Exchange (KASE) has two categories on its official listing. Category A is designated for enterprises with active securities trading exceeding preset volume thresholds and presenting regular price-quotations. Category B envisages more sporadic trading, with no volume thresholds stipulated and prices quoted periodically. Currently there are a total of 79 enterprises officially listed (47 A Listed and 32 B Listed). During 2004 there were a total of 17 share issues (11 A Listed and 6 B Listed) and 35 bond issues (32 A Listed and 3 B Listed). The total market capitalization of securities included in the KASE official A and B listings at the end of 2004 amounted to US\$9.2 billion, an increase of over 68 percent compared to 2003.

9. Kazakhstan was among the first CIS countries to promulgate accounting standards, initially setting a policy in 1995 of developing National Accounting Standards "based on" International Accounting Standards; the first of these were adopted in 1996. Furthermore, Kazakhstan was one of the first CIS countries to adopt a law on audit activities, which established the concept of auditing standards. As a result, the process of accounting and auditing reform is more advanced in Kazakhstan than in most other CIS countries. However, as this report shows, much remains to be done if Kazakhstan wants to raise the quality of accounting and auditing practices to a level in line with developed economies.

10. This report focuses on the principal reason for continuing with further reforms, specifically, on the benefits that the proposed reforms will bring to Kazakhstan and its citizens. In this context, this report sketches policy recommendations to enhance the quality of corporate financial reporting and foster a financial reporting platform conducive to sustainable private and financial sector growth, thus increasing access to global financial markets and other tools of market economy.

II. INSTITUTIONAL FRAMEWORK

A. Statutory Framework⁴

11. **The Civil Code stipulates that a commercial enterprise may be established only as one of four legal forms.** These are a state-owned enterprise (SOE), a business partnership, a joint-stock company or a production cooperative. As of the date of this report, there were

⁴ This report outlines the legal principles applicable with regard to accounting, auditing and financial reporting and does not attempt to give anything more than an introduction to the issues. This report is not meant to be an exhaustive rendition of the law nor is it legal advice to those reading it.

approximately 5,400 SOEs; 125,000 business partnerships; 2,700 joint stock companies; and 4,000 production cooperatives.⁵

12. **Accounting in Kazakhstan is generally governed by the provisions of the Law on Accounting and Financial Reporting (the “Accounting Law”).**⁶ The Accounting Law was amended on February 28, 2007. Under the new Law, individual entrepreneurs using a special taxation regime in accordance with taxation legislation do not have to keep books and compile financial reports. All other categories of small and medium-sized enterprises (SMEs) are required to report using KAS, developed on the basis of IFRS. The most simplified KAS will be developed for subjects of small entrepreneurship such as those who use simplified taxation declarations. The new Law does not restrict SMEs from choosing to apply IFRS.

13. **Public interest entities (PIEs) as well as large companies are be required to apply IFRS.** The term public interest entities is defined to include joint stock companies (excluding non-for profit organizations), financial institutions, companies with state participation, self-supporting public economic entities and certain extractive industry companies. This approach addresses the problem of applying IFRS in organizations for which IFRS was not designed or intended.

14. **The legal requirements of what financial statements should be publicly available are summarized in the table below:**

Type of Organization	Balance sheet	Income Statement	Cash Flow Statement	Statement of Changes in Equity	Notes	Audit Report	Refer to Paragraph
Joint Stock Companies	Yes	Yes	Yes	Yes	No	No	15
A Listed Companies	Yes	Yes	Yes	Yes	Yes	Yes	16
B Listed companies ⁷	Yes	Yes	Yes	Yes	No	Yes	16
Banks	Yes	Yes	No	No	No	Yes	18
Insurance companies	Yes	Yes	No	No	No	Yes	n/a
Pension funds	Yes	Yes	Yes	Yes	No	No	n/a
SOEs	Yes	Yes	Yes	Yes	No	Yes	19

15. **Under the provisions of the Law on Joint-Stock Companies, a shareholder is entitled to receive information on company’s activities, including the financial statements, in the form determined by the General Shareholder Meeting or the Charter.** This Law also requires an audit in all joint stock companies but does not require companies to make the audit report publicly available. This Law also requires that annual financial statements and the auditors’ report should be ready for shareholders’ scrutiny no later than 10 days before the General Shareholder Meeting. This Law also requires that a company must publish in mass media a balance sheet, income statement, cash flow statement and a statement of changes in equity. The Law does not explicitly state that consolidated financial statements are required. In practice, consolidated financial statements are not readily available.

16. **The Law on Securities Market requires any company making an Initial Public Offering (IPO) to disclose information included in financial statements to any interested**

⁵ Source: State Statistical Agency of Kazakhstan.

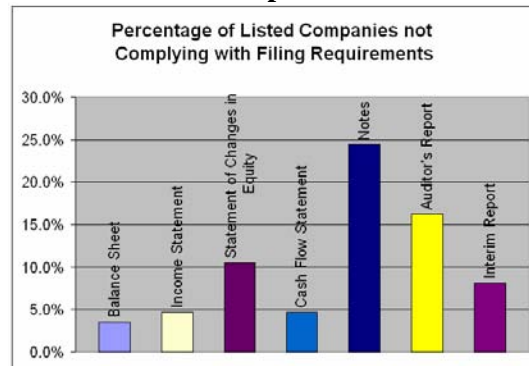
⁶ The Law on Accounting 1995 was amended in 1998 to become the Law on Accounting and Financial Reporting with a further significant amendment in 2003 and is still subject to potential amendment.

⁷ Given the lack of a requirement to apply any specific accounting or financial reporting standards it is assumed that the B Listed Companies will be required to meet the requirements of the Law on Joint-Stock Companies with the additional requirement of an audit report (refer to Paragraph 16).

party. The Law also requires that this information should be provided through both an authorized agency as well as being published in mass media. The requirements to publish financial statements for companies already listed are regulated only by listing rules of the Kazakh Stock Exchange (KASE). Issuers should submit their quarterly and annual reports (including financial statements) to the KASE. Issuers in the highest listing category (Category A) are required to prepare their financial statements in accordance with IFRS. However, issuers in the lower listing category (Category B) may use either IFRS or KAS as reporting standards.

17. The KASE discloses the information it receives from listed companies on its website.

However, there appears to be little or no checking of the information by the KASE, resulting in information that is of variable quality and is often less than would be expected for companies which purport to present financial statements in compliance with IFRS. As shown in Figure 2, noncompliance with statutory financial reporting requirements involves mainly the omission of the notes to the financial statements and the auditor’s reports.



18. While the Law on Banks requires banks to publish an annual report, there is no requirement to make consolidated financial statements publicly available. The Law requires publication of an annual report, including a balance sheet and an income statement, after the audit has been carried out and the financial statements have been approved by the General Shareholder Meeting. Banks having subsidiaries are also obliged to prepare consolidated financial reports in the same format, which are submitted to the owners and the Agency for Financial Supervision (AFS), which supervises the banking sector, the insurance sector, the securities market and the pension funds. The requirement to publish audited consolidated balance sheets and income statements, using standard forms, is specified in the Board’s Decree of the National Bank of Kazakhstan. However, such forms have only limited value for users and can not be considered as consolidated financial statements. This differs from the spirit of Principle 21 of the Core Principles for Effective Banking Supervision issued by the Basle Committee on Banking Supervision. As a consequence, depositors and other creditors may face considerable difficulty in getting sufficient information about the financial condition of banking groups.

19. The Resolution of the Government of Kazakhstan No. 290, dated February 28, 2001, requires that annual audited financial statements of SOEs be published in the Kazakhstan mass media with a circulation exceeding 30,000 copies. The format of the published financial statements is approved by Ministry of Finance. The Resolution does not state explicitly whether consolidated financial statements are required.

20. Therefore, although for most public interest entities there is a requirement to publish their financial statements in Kazakh mass media, this does not ensure that published (consolidated) financial statements are either complete or easily located. As discussed above, the scope of what is required to be published is too restrictive for user needs, especially the lack of notes to the financial statements, and the media chosen is often not user-friendly. During the course of its mission, the ROSC team found it very difficult to obtain (consolidated) financial statements of non-listed companies. Many large companies do not disclose their financial statements on their websites; direct requests to management of a number of large companies and SMEs to provide their financial statements for the purpose of ROSC mission were declined. The

recent amendments to the Accounting Law in 2007 allow the Government to set up a depository where all PIEs must file their financial statements, which would improve the availability of information.

21. **The new Law on Audit Activity, which was adopted in May 2006, stipulates the use of International Standards on Auditing (ISA) in the conduct of audits in Kazakhstan starting from November 2006.** The previous Audit Law (1998) required that auditing standards be adopted by the Republican Chamber of Auditors (COA) and approved by the Ministry of Finance. The COA drafted auditing standards and submitted the draft standards to the Ministry of Finance for approval. As discussed in Paragraph 50 below, this process has led to significant confusion within the audit profession as to precisely what auditing standards are to be applied.

22. **Auditors are required to be insured against liabilities arising from the consequences of damage when conducting an audit.** However, the Audit Law is silent on the minimum amount of insurance required and the extent to which auditors can incur civil liabilities is unclear. The Law on Obligatory Insurance of Civil Liability of Audit Institutions regulates the mandatory insurance of civil liability for auditors and establishes procedures for its operation.

23. **The new Audit Law has also introduced a number of other significant changes, generally for the better, to the statutory framework for auditing.** These changes include:

- Mandatory membership of all auditors in a professional association (the Law envisages more than one professional association);
- The requirement for individual auditors to be members of only one audit firm at a time (sole practice no longer permitted);
- Requirement for audit firms to have at least three auditors and a system of internal quality control, and that auditors own a majority of the shares of the audit firm.
- The professional associations to become responsible for oversight of their members under the control of the Ministry of Finance; and
- The professional associations to appoint representatives to the Qualification Commission (QC), which will be a separate legal entity.

While this report supports the intent of most of the proposed changes, this report makes recommendations that go beyond the amendments above with a view to ensure that Kazakhstan catch up with more developed economies. Limited reforms would be inconsistent with the ambitious objectives Kazakhstan has set for itself.

24. **From a policy standpoint, there appears to be a lack of knowledge-sharing within the AFS to develop a unified audit regulatory platform for the entities it regulates.** For example, while banks have to inform the AFS of the appointment of external auditors selected among those approved by the AFS, there is no equivalent requirement in the insurance sector. Also, while there is no requirement for auditor rotation in the banking sector, there is a proposed amendment to the Law on Insurance Activities so as to make it mandatory for insurance undertakings to change auditors every three years. While this report does not form a view about the merits of rotation, regulatory harmonization is highly recommended with a view to (a) make efficient use of scarce regulatory resources, (b) reduce the regulatory burden, and (c) avoid unnecessary impediments to business.

B. The Accounting and Auditing Profession

25. **The recently amended Accounting Law enacted in 2007 establishes requirements for the certification and competence of professional accountants.** A professional accountant is defined as a person who has professional accountant's qualification. Professional accountant qualifications awarded by foreign institutions which are full members of IFAC are also recognized alongside qualifications awarded by Kazakh organizations of professional accountants. .

26. **The Chamber of Professional Accountants and Auditors (CPAA) is positioned as a professional body of accountants.** It has 1,127 individual members, mostly holding the basic Certified Accounting Practitioners (CAP) qualification, with only a few members holding the higher status of Certified International Professional Accountants (CIPA). Members of the CPAA work in all employment sectors, in public practice offering their services to the public, in industry, commerce, the public sector and in education. Membership of a professional body is voluntary for accountants working in industry, commerce, the public sector and education.

27. **At the present stage of development the focus of the activities of the CPAA is on the promotion of the CAP and CIPA entrance qualifications,**⁸ discussed in Section II C below. The CPAA indicated that professional rules for its members have been published but the ROSC team could find little evidence that individual members were aware of the rules' existence. In order to more fully develop the functions of a professional body, the CPAA has joined the Eurasian Council of Certified Accountants and Auditors.

28. **The size of the audit profession is currently very small compared to the number of enterprises whose financial statements are subject to statutory audit.** The COA currently has 424 individual and 114 legal entity members. The number of general audit licenses issued by the Ministry of Finance as at November 2005 was 412 individual auditors and 234 firms. Of these, 28 firms had licenses for bank audit, 36 for insurance company audit, and eight for pension fund audit. A significant number of these memberships and licenses were granted to auditors certified by the QC under a grandfathering scheme and who have therefore not passed examinations based on IFRS and ISA.

29. **The COA is a federation of chambers of auditors governed by the Republican Chamber of Auditors which coordinates the activities of Regional Chambers of Auditors.** Its mandate is to represent the interests of auditors, audit firms and the Regional Chambers of Auditors in state bodies, public associations, foreign and international associations; develop audit standards on the basis of international practices whilst ensuring that auditors and audit companies adhere to audit standards; review audit-related disputes of auditors, audit firms and entities under audit; organize the training and preparation of audit candidates for certification, professional education; improve the qualifications of auditors and other specialists; apply to an authorized state body with proposals to withdraw or suspend audit licenses; and engage in other activities that do not contradict legislation and international agreements.

30. **The certification of auditors is regulated in the Audit Law and auditors are certified by the Qualification Commission (QC).** Individuals with higher education and who have three

⁸ The CAP/CIPA program is a United States Agency for International Development (USAID) initiative that addresses the qualification of professional accountants. The goal of the CAP/CIPA program is to create professional accountants that meet international technical and professional standards but are also prepared in the competencies required in their unique environment of transitional economies. In addition, the program aims to promote regional economic and professional integration, by creating a common certification network that can be implemented in all of the countries of the CIS.

years work experience out of the previous five in economics, finance, accounting, analysis, audit or law can sit the audit certification examination, as can persons involved in academia and teaching in higher educational institutions (in the areas of accounting and audit).

31. **The COA will recognize a qualification of another country only when there is a mutual recognition agreement with that country.** This effectively means that qualified auditors from abroad have to pass all examinations of the QC in order to obtain an auditing license in Kazakhstan, thus acting as a barrier to recruiting qualified auditors from other countries.

32. **The new Audit Law enables the COA to act as a supervisory body over audit professionals.** The COA has the authority to apply to the Ministry of Finance to withdraw, suspend or revoke audit licenses, and it is required, and has the authority under the new Audit Law, to undertake the external quality control of its members. Similarly the QC can revoke an auditor's qualification certificate where: intentionally false or unqualified audit reports have been issued; the basic requirements of audit standards have not been observed; legislation has been otherwise violated when carrying out professional activities; or when the auditor has failed to pass the quality control examination of the COA.

33. **Although the Audit Law gives the Ministry of Finance responsibility for supervision of the audit profession, the actions currently undertaken with regard to issuing and revoking of licenses, particularly in relation to monitoring the quality of the audit process in Kazakhstan, falls short of what is considered international good practice.** In addition to a more effective monitoring regime, international good practice involves public oversight of the audit profession. While the Ministry of Finance is one of the stakeholders, it cannot adequately reflect these diverse interests of all stakeholders (e.g., investors, lenders, regulators) in the oversight of auditors. The public oversight system should have the ultimate responsibility for the oversight of the approval and registration of statutory auditors and audit firms, the adoption of standards on ethics, internal quality control of audit firms and auditing, and continuous education, quality assurance and investigative and disciplinary systems.

34. **While the COA is bound by IFAC Statements of Membership Obligation (SMOs),⁹ the COA does not yet comply with all SMOs.** The Chamber is a full member of the International Federation of Accountants (IFAC) and of the Eurasian Council of Certified Accountants and Auditors. Specifically, the COA currently falls short of the SMOs in regard to SMO 1, *Quality Assurance*; SMO 6, *Investigation and Discipline*; SMO 2, *International Education Standards for Professional Accountants and Other EDCOM Guidance* (refer to Section II C below); and SMO 4, *IFAC Code of Ethics for Professional Accountants*.

35. **The Code of Ethics adopted by the COA, to be complied with by its members, was derived from the IFAC 1998 Code of Ethics but does not have the status of a regulatory document and only members of the COA are required to abide by it.** The COA Code falls short of the current IFAC requirements, which have been significantly enhanced, especially where they relate to independence requirements. In addition, the ROSC team noted several instances where the existing Code was not being complied with.

C. Professional Education and Training

⁹ IFAC SMOs are designed to provide clear benchmarks to current and potential IFAC member organizations to assist them in ensuring high quality performance by accountants worldwide. SMOs cover quality assurance, education standards, auditing standards, ethics, investigation and discipline, etc. For additional information, refer to <http://www.ifac.org/Compliance/index.php>.

36. **The education of accountants and auditors in Kazakhstan needs to be enhanced**¹⁰. The ROSC team concluded that business and economics education is not responding to the evolving needs of the economy and business and more emphasis should be given to continuing education, short term training and certification.

37. **The business community reported difficulties in recruiting accounting and finance graduates of suitable quality and there remains a chronic shortage of qualified instructors at all levels.** Few university lecturers have experience of, or qualifications in, IFRS-based financial reporting and as a result most university accounting and finance syllabi are still based on the financial reporting system developed during the Soviet era. Additionally, there is evidence that assessment at many universities is insufficiently rigorous to engender confidence in graduates' competence in accounting and related topics.

38. **A start has been made with the integration of professional qualifications in the university curriculum.** A USAID project is promoting the implementation of CAP/CIPA courses in the university curriculum. During the academic year 2005 – 2006 at least 89 courses in CAP subjects have been offered at universities. The Ministry of Education is starting an experiment with two State Universities to bring in expertise from abroad. However, more needs to be done to harmonize the accounting and finance education in universities with the needs of the developing Kazakh economy in general and the accounting profession in particular.

39. **As noted in Section II B, post-graduate professional accountancy education is based on the CAP/CIPA examinations and the ACCA diploma in IFRS (both are taught and examined in Russian). The CPAA qualification uses the two level CAP/CIPA assessment regime, whereas the QC uses the CAP/CIPA examinations but undertakes its own assessment.** This raises the prospect that the same examination answer might pass under one assessment regime but fail under the other due to inconsistency in assessment. The ROSC team, however, found no indication that the assessment criteria set by the QC results in significantly different pass rates from the assessment criteria used for QC candidates (that is those who will be eligible to become auditors) and those used for CPAA candidates.

40. **Overall, examination standards are high and the examinations are set and assessed under strict regulations.** Final responsibility for the assessment of potential auditors rests with the QC. Representatives of state bodies act as observers to the process but have no direct input into the assessment process, which rests solely with the QC.

41. **Examination standards are high and pass rates are low.** This is particularly true of the higher level CIPA examinations and is linked to the shortage of qualified instructors. While teachers for the CAP level of the professional qualification are becoming available, it is very difficult to find qualified teachers for the more advanced CIPA level. Moreover, teacher availability is perceived to be much better in Almaty than in the rest of the country. In this context, there is scope to leverage the initiatives being taken by the Ministry of Education to improve academic education to increase the availability of materials and instructors appropriate to the higher level examination throughout the country.

¹⁰ The conclusion of the ROSC team are supported by the findings of the USAID funded Central Asian Region Business Survey – 2005, which provides a four-country study of business and economics education programs from the perspective of private enterprise business leaders.

42. **Despite the CAP/CIPA examinations covering an important part of the content requirements in International Education Standards (IESs)¹¹ and internationally recognized practices such as the requirements of the new Eighth EU Company Law Directive on statutory audit, the professional qualification process in Kazakhstan is not yet comprehensive.** The CAP/CIPA examinations cover the following subjects:

- First Level (CAP):
 - Financial Accounting I
 - Management Accounting I
 - Tax
 - Law
- Second Level (CIPA):
 - Financial Accounting II
 - Management Accounting II
 - Finance
 - Audit
 - Management Information Systems

Therefore, together taken together with university education, the accounting education in Kazakhstan addresses the requirements of IES 1 and IES 2. Other IES are not as yet fully addressed.

43. **In common with most transitional countries, the development of professional skills, values, ethics and attitudes in Kazakhstan needs increased attention.** In IES 3, a relatively new approach to skills is defined. Required skills include intellectual skills; technical and functional skills; personal skills; interpersonal and communication skills; and organizational and business management skills. These should be acquired both in education and in practical experience. Assessment of a broad range of skills in written examinations is limited. A competence approach should be developed with evidence of skill development documented in recorded of structured practical experience. IES 4 requires a framework of professional values, ethics and attitudes for exercising professional judgment and for acting in an ethical manner in the best interest of society and the profession. This is perhaps best assessed via an examination based on an extended case study where candidates can demonstrate that issues are considered within an appropriate framework of professional values, ethics and attitudes.

44. **Existing practical experience requirements in Kazakhstan are not yet compliant with international standards.** IES 5 requires a minimum of three years of practical experience (a similar requirement exists in all EU Member States). This condition is only nominally met in Kazakhstan. Present regulations for the COA require that candidates finish their practical experience before they can sit the examinations. The examinations must be passed in three and a half years for results to remain valid. However, the COA has no associate membership for candidates and there is no specific regulation on the content of practical experience. This means that practical experience may not be structured and that there are no safeguards that the experience obtained by candidates is consistent with the skills an auditor should acquire. The approach to practical experience by IFAC and the EU is different from the present situation in Kazakhstan in that they require that practical experience is gained in a suitable professional

¹¹ IFAC International Education Standards are set out by the International Education Standards Board of IFAC. They comprise of IES 1, *Entry Requirements to a Program of Professional Accounting Education*, IES 2, *Content of professional Accounting Education Programs*, IES 3, *Professional Skills*, IES 4, *Professional Values, Ethics and Attitudes*, IES 5, *Practical Experience Requirements*, IES 6, *Assessment of Professional Capabilities and Competence*, IES 7, *Continuing Professional Competence*, and IES 8, *Competence Requirements for Audit Professionals* (draft).

environment, is relevant, monitored and supervised and that the professional body or regulatory authority must take responsibility for the system of practical experience.

45. **Continuing Professional Development (CPD) is required by both the COA and the CPAA but actual measures to ensure compliance are not yet in place.** The situation in Kazakhstan resembles the situation in the recent past in for example the EU and the United States when CPD was mandatory but the sole responsibility of the individual member. Nowadays, IES 7 also sets standards for the content of CPD, the monitoring and disciplining by professional bodies. The professional bodies are also expected to promote and facilitate CPD. Therefore, both the COA and the CPAA should ensure that sufficient appropriate CPD courses and materials are available so that members can meet their CPD commitments. They should also institute monitoring procedures so as to ensure members do meet those commitments.

46. **IES 8 treats the auditor qualification as a follow up to the qualification of a professional accountant; its additional requirements on education and experience are not yet covered in Kazakhstan.** Currently, in Kazakhstan there is no distinction between the accounting qualification and the auditing qualification and the CAP/CIPA examinations, designed as they are as an accounting qualification, do not meet the requirements of IES 8. IES 8 specifically states that audit professionals need an “advanced level” of knowledge in the financial statement audit subject area. The QC therefore needs to consider how such advanced knowledge should be assessed in order to certify professional auditors as distinct from professional accountants.

47. **Despite the issues noted above, evidence gathered by the ROSC team suggests that Kazakhstan probably has the strictest qualification procedures in the region.** The COA, as one of the founding partners of the Institute of Professional Accountants and Auditors (engaged in offering education and training for future members of the profession) is demonstrably taking active steps to improve the quality and quantity of professional education throughout the country. To date the Institute has trained 4,500 students following a curriculum that is fully approved by the COA and the Eurasian Council of Certified Accountants and Auditors.

D. Setting Accounting and Auditing Standards

48. **The recently amended Accounting Law requires that all public interest entities and large businesses prepare their financial statements in accordance with IFRS. All other entities (except public institutions) prepare their financial statements in accordance with KAS.** Thus a certain part of the accounting and financial reporting standards applicable in Kazakhstan are set by the IASB. The Accounting Law states that the Ministry of Finance of Kazakhstan is responsible for the development and approval of the national accounting and financial reporting standards, KAS.

49. **The National Bank of Kazakhstan (NBK) is required to draft and approve the recommended procedures applying to accounting standards for banks, with respect to matters not regulated by IFRS and not in opposition to any such standards.** There is a potential risk of remaining residual conflict between regulatory requirements and IFRS. Such conflict is common in many countries that use IFRS, and needs to be considered.

50. **The Ministry of Finance was, prior to the recent amendments to the Audit Law, the body authorized by the Audit Law to promulgate auditing standards.** Historically, promulgating auditing standards was a two part process whereby auditing standards were adopted by a conference of the Republican Chamber of Auditors and then approved by the Ministry of

Finance. The COA adopted six National Standards on Auditing (KSA) based on ISA in 1998, a further six in 1999, and 36 revised KSA in 2000. However the Ministry of Finance approved only eleven of these, resulting in an auditing regime that fell significantly short of ISA. Consequently, there was and is a great deal of confusion among auditors with regard to which standards should be applied: those approved by the Ministry of Finance only, the full set, as adopted by the COA, or current ISA. The new Audit Law enacted in May 2006 requires audit to be performed in accordance with ISA. However, there is a significant risk that the majority of local practitioners is not familiar with ISA and will, therefore, struggle with compliance with the law. In April 2006, the Ministry of Finance funded the translation of ISA into Russian and Kazakh in cooperation with the Chamber of Auditors (which has been a full IFAC member since 2000).

E. Enforcing Accounting and Auditing Standards

51. **On January 1, 2004 the supervision and regulation of the banking sector, the insurance sector, the securities market and the pension funds was taken over by the Agency of Kazakhstan on Regulation and Supervision of Financial Markets and Financial Organizations, generally referred to as the Agency for Financial Supervision (AFS).** The AFS's stated aim is to refine and improve the system of regulation of the financial sector to establish independent and effective financial supervision in order to improve the level of protection of financial services consumers and maintain stability in the domestic financial market.

52. **While NBK regulates the system of accounting and financial reporting in banks through adoption of regulations and supporting methodological recommendations, the AFS is responsible for monitoring compliance with the accounting, reporting, and auditing requirements for banks.** The Banking Supervision Department in the AFS fulfills the monitoring function. The department employs 33 people, including 13 for off-site supervision and 20 for on-site supervision. Banks are required to submit a wide range of prudential reports with frequencies ranging from daily to weekly, monthly, quarterly, and annually. The key reports in this process are quarterly balance sheet and income statements. Accuracy of off-site reporting is verified through on-site examinations.

53. **In addition to the statutory audit the AFS may require the banks' accounting records and reports, primary documents and other information about their activities to be audited by an audit firm of its choosing.** If the AFS requires a copy of the audit report, the bank's auditor is required to submit it directly to the AFS. Additionally, auditors are required to report directly to the AFS any violations of the legislation of Kazakhstan.

54. **In practice, AFS supervisors do not tend to use audited financial statements in the course of their supervisory activities.** There is no tradition or culture for bank supervisors to rely on the work of independent auditors. Instead, supervisors rely on examination of prudential reports and their own investigations. Since the prudential norms set by the AFS generally address the risk issues, both off-site and on-site supervisors give priority to checking the compliance with these requirements during their examinations. The audited financial statements of many banks for 2004 were not checked by the supervisors in terms of the accounting and reporting requirements.

55. **While sanctions against banks for non-compliance with reporting requirements are set out in the Banking Law and the Administrative Violations Code, the ROSC team could not find a single instance where these sanctions have been exercised despite many instances of noncompliance.** The Banking Law stipulates that, in instances where a bank fails to submit reports or where it submits deliberately untrue reports and data to the authorized body, the bank can have its banking license suspended or revoked. The Administrative Violations Code provides

for monetary fines for both the corporate and individual bank officers for non-compliance with regulations concerning accounting records and financial statements. Furthermore, the Code also imposes civil sanctions on individuals who deliberately present false or inaccurate information to bank auditors and on auditors who reach “inaccurate conclusions.” The Criminal Code also provides for sanctions against individual bank officials and statutory auditors of banks.

56. **The Insurance Supervision Department of the AFS is responsible for monitoring compliance with the accounting, reporting, and auditing requirements for insurance companies.** The department employs 34 persons, of whom 14 work as on-site supervisors. Also, they regularly receive 28 reports on different issues for off-site supervision. The department controls compliance with the requirements regarding timeframes, completeness and reliability (quality) of financial reports and applies measures of influence and sanctions in the event of non-compliance with accounting and audit requirements.

57. **The Administrative Violations Code sets out monetary fines for non-compliance by insurance and reinsurance companies with regulations relating to accounting records and financial statements.** The sanctions can be applied to both individual officials of insurance companies and the corporate entities. As in the banking sector, the Code also imposes civil sanctions on the auditor for reaching “inaccurate conclusions” and on officials for presenting inaccurate information to an auditor. The Law on Insurance Activities gives the AFS the authority to issue binding instructions to an insurance company to implement corrective measures to eliminate deficiencies identified in the course of its supervisory activities. Ultimately, the AFS has the right to suspend or revoke insurance licenses. The AFS has exercised its powers, issuing a number of injunctions to insurance companies regarding the submission of unreliable reports.

58. **Neither the AFS nor the KASE has prioritized the monitoring and enforcement of compliance with IFRS or KAS in listed companies.** It is clear that the priorities of the AFS have been directed towards prudential regulation and supervision rather than with enforcement of accounting standards to be applied to general purpose financial statements. As discussed in Paragraph 17 above, the KASE posts the information it receives from listed companies on its website with little or no checking of the information to ensure compliance with accounting standards.

59. **In order to promote more effective enforcement of IFRS (or KAS), the AFS should adopt internationally accepted principles of accounting standard enforcement.** This report has regard to Standard No. 1, *Enforcement of Standards on Financial Information in Europe*, set forth by the Committee of European Securities Regulators (CESR) as a possible reference for the AFS.¹² Standard No. 1 sets out 21 fundamental principles of enforcement considered by the European Securities Regulators as essential for furthering the objectives of investor protection and the integrity and transparency of financial markets.¹³

60. **Although considerable effort has been made, further work is needed to ensure that monitoring can be conducted at a level and intensity to provide a system that is capable of meeting the more exacting demands of enforcement within a framework founded on principle-based IFRS.** Comparing the evidence of the efforts made to introduce enforcement

¹² CESR was established under the terms of the European Commission’s Decision of June 6, 2001. In summary, the role of CESR is to improve coordination among securities regulators, act as an advisory group to assist the European Commission, and ensure more consistent and timely day-to-day implementation of community legislation in EU Member States.

¹³ A more detailed discussion of each of these principles is contained in Appendix I to this report.

arrangements in Kazakhstan against the principles of CESR Standard No 1, the following should be noted:

- The establishment of the AFS is part of the policy to establish an independent and effective system of state regulation of the financial market. The overall financial resources available to the AFS appear adequate given the current size of the financial market and it has the power to obtain such information as it requires in order to fulfill its functions. However, there is a lack of IFRS qualified staff, which makes the specific task of monitoring compliance with IFRS extremely difficult.
- There is clear evidence that the financial information provided by those organizations seeking admission to trading is scrutinized. However, scrutiny of the financial information supplied by issuers subsequent to admission to the market is less rigorously applied.
- Perhaps as a result of the lack of IFRS qualified staff, there appears to have been little monitoring of compliance with IFRS within the published financial statements of listed companies, with a far greater emphasis placed on administrative issues such as late filing. This has resulted in a situation where investors do not receive all the information that they are entitled to expect with no corrective action being taken by the AFS as documented in Section III of this report.
- The evidence regarding compliance with regulations relating to the provision of financial information by listed companies shown in Figure 2 in Paragraph 17 above, shows that there is currently an unacceptably high level of non-compliance. The primary role of the enforcer should be to ensure that all the required information is both materially correct and available to the market so as to promote capital market efficiency. The AFS should prioritize taking remedial action to ensure that the market is supplied with the information to which it is entitled.
- The AFS needs to establish a system of examining financial information so as to ensure compliance across all listed companies and therefore it would be normal to examine documents of companies even when there was no suggestion of any non-compliance. However, given the limited number of IFRS qualified personnel at the AFS at the current time, an approach that concentrated on those companies where the risk of non-compliance was highest would be acceptable. In the first instance it would be sensible to ensure that all companies that had qualified auditor's reports be investigated so that material non-compliance with IFRS in the information available to the public could be rectified.

61. **There is little evidence of active enforcement of auditing standards, since (as noted in Section II B of this report) the COA has not acted as an effective supervisory body over the audit profession. It is critical that there is an effective supervisory body, or bodies, with powers to monitor and investigate the conduct of statutory audits.** Proper audit of financial statements is essential if users are to consider the information contained in them relevant and reliable and thus useful in making economic decisions. The audit function is an important pillar of enforcement for accounting standards and if it is not effective the level of non-compliance, especially by non-regulated entities, is likely to be high. This was borne out by the compliance gap analysis detailed in Section III of this report.

III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

62. **The purpose of this section is to perform the accounting *standard gap* analysis and *compliance gap* analysis.** The *standard gap* analysis compares Kazakh Accounting Standards

(KAS) with IFRS in order to identify significant differences, which may adversely impact the reliability of KAS-based financial statements (refer to Paragraph 63 below). The *compliance gap* analysis focuses on the compliance of the statutory and voluntary/contractual (e.g., required by a lender) financial statements with KAS and IFRS, respectively, in order to identify any shortcomings in the accounting standard monitoring and enforcement pillars in Kazakhstan (refer to Paragraph 64 below).

63. **While there is a generalized belief that IFRS and KAS (for the enterprise and financial sectors) are broadly aligned, the gaps are quite significant.** There are significant differences between the accounting policies used and disclosures made under KAS and those which would be required under IFRS. This suggests that the differences between KAS and IFRS are greater than claimed. The following paragraphs highlight the most significant differences between KAS and IFRS and their likely impact on the financial statements of *public interest entities*:

- ***The carrying value of property, plant and equipment (PPE) under KAS differs significantly from that under IFRS.*** Though Kazakhstan was hyperinflationary for a number of years following the collapse of the Soviet Union in 1991, there is no requirement in KAS similar to IAS 29, *Financial Reporting in Hyperinflationary Economies* to apply adjustments to non-monetary assets and liabilities. Companies revalued PPE using “capital assets coefficient cost increases determined by the State Committee of Kazakhstan on Statistics and Analysis.” While the actual impact of this treatment will differ from entity to entity and asset to asset (e.g., depending on the acquisition date of the asset), the carrying value of PPE under KAS is generally overstated (as compared to IFRS), especially in large production companies. This issue is compounded by the lack of impairment test as discussed below.
- ***Impairment of assets (PPE) may not be recognized.*** There is no equivalent to IAS 36, *Impairment of Assets*, in KAS, which may lead to the overstatement of PPE. In the current booming economic climate, the provisions of IAS 36 may not be significant to many sectors of the economy. However, in enterprises where assets have remained underutilized or idle since the time of the collapse of the Soviet Union, the provisions of IAS 36 are likely to be highly relevant. Additionally, in the event of a change in the economic climate the impact on large production companies and real estate developers may become material.
- ***Recognition and measurement of financial instruments.*** There is no equivalent of IAS 39, *Financial Instruments: Recognition and Measurement*.¹⁴ There is no concept of financial instrument or fair value measurement in KAS. The requirement to value investments based on whether they are held up to one year or over one year may lead to misstatement of the investments compared to IAS 39 requirements. In addition, as only banking institutions are allowed to charge interest on loans, all loans received from other organizations (for example, inter-company loans) are interest free. Such loans are recorded at cost in the financial statements of the borrower and the lender. The recording of such loans at historical cost may again lead to an understatement of the financial liability of the borrower and an overstatement of the financial asset of the lender. Given the pervasiveness of such arrangements in Kazakhstan, the measurement principle under KAS 8 may significantly mislead users of financial statements and raises significant concerns about the stewardship of the lender. Also, the review of KAS financial statements noted that preparers do not disclose these

¹⁴ KAS 8, *Accounting for Financial Investments*, is based on IAS 25, *Accounting for Investments*, which was superseded when IAS 39 became effective in 2001.

long-term loans that carry no interest, although in several instances information gathered during the ROSC due diligence mission indicated that these loans were actually related party transactions (refer to Paragraph 68 below).

- ***Provisions for employment benefits may be understated.*** KAS do not have a standard similar to IAS 19, *Employee Benefits*. While pension schemes based on defined benefits are non-existent for the majority of Kazakh companies, many large SOEs and some other *public interest entities* do have such plans and/or other one-off retirement payments or other long-term employee benefits. The failure to record such provisions results in an understatement of liabilities and expenses in the financial statements of *public interest entities*. In SOEs, this actually mean that the State may face large, unaccounted-for pension liabilities.
- ***Provisions for legal or constructive obligations may be understated.*** There is no standard similar to IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, though contingent liabilities and contingent assets are briefly addressed in KAS 27, *Unpredicted Items and Subsequent Events*. The absence of clear requirements to record provisions and related expense in accordance with IAS 37 results in an understatement of provisions and expenses related to product warranties, onerous contracts, restructuring, penalties or clean-up costs for environmental damage or for decommissioning costs for certain types of fixed assets.
- ***Deferred tax liabilities may be under- or overstated.*** KAS 11, *Accounting for Income Tax*, on accounting for deferred tax is based on the original version of IAS 12, *Income Taxes*, and does not include recent IFRS revisions. The original IAS 12 and revised IAS 12 use different approaches to determine the deferred tax liability/asset (income statement approach vs. balance sheet approach), which may result in a different deferred tax position in the financial statements of a company. Specifically, the original IAS 12 did not require an entity to recognize a deferred tax liability in respect of asset revaluations, while the revised IAS 12 prescribes the recognition of such liability. Following the national accounting rules based on original IAS 12 may lead to significant understatement of the deferred tax liability in the financial statements of *public interest entities* which have revalued their assets.
- ***KAS do not contain any provision similar to IAS 41, Agriculture.*** Agricultural enterprises apply a transaction-based, historical cost accounting model and, therefore, do not report any income until the sale of produce. Bookkeeping is done in accordance with the Model Chart of Accounts and Methodical Recommendations developed by the Ministry of Finance and costs incurred as a result of agricultural activities are initially posted to a “temporary manufacturing account” and subsequently transferred to “inventories of finished goods” at harvest and “cost of goods sold on eventual sale.” In practice specific cost allocation approaches, based on former Soviet Union regulations, are applied to each group of biological assets. For example, dairy livestock will be valued as the gross costs incurred during the period and are allocated to dairy and newborn animals based on a standard allocation rule, i.e. 90% to dairy and 10% to newborn animals. As approximately one-third of population is employed in this sector, the lack of relevant and reliable measurement principles may distort the allocation of resources, since the existing formulaic accounting treatment does not give a true and fair view of the financial condition and performance of the sector.

64. **The ROSC team conducted a *compliance gap* analysis, which shows that the quality of the financial statements prepared by the majority of enterprises in practice falls far short**

of the standard implied in the reporting requirements embodied in statutory framework.

The ROSC assessed the *compliance gap* sampling:

- **11 sets of audited financial statements, which purport to be prepared in accordance with IFRS.** For the sample review, the ROSC team selected six enterprise sector companies and five banks.¹⁵ The results of the review are set forth in Paragraphs 65 and 68 below.
- **14 sets of audited and four sets of unaudited financial statements, which purport to be prepared in accordance with KAS.** For the sample review, the ROSC team selected 16 enterprise sector companies (listed and unlisted), and two insurance companies.¹⁶ The results of the review are set forth in Paragraph 69 below.

65. **The IFRS consolidated financial statements often include a considerable amount of standard wording, which may not deal adequately with the events and circumstances of that company.** The standard wording is usually drawn from model financial statements provided by the audit firms. In several cases, the standard wording includes accounting policies for events and transactions, which are not relevant to the companies concerned. According to some, the use of standard wording reflects the lack of knowledge and understanding of IFRS and IFRS financial statements among accountants employed by companies. The audit firms assert that they do not “prepare” the financial statements and that they only assist as far as is ethically possible. The standard wording also reduces the relevance of those financial statements to external users.

66. **While the quality of bookkeeping for cash and similar transactions is of a high level, companies struggle to deal with accrual accounting and disclosures.** Companies are able to cope well with cash and similar transactions as a result of the disciplines imposed under the former state-controlled regime. Companies are less able to cope with accrual accounting, which requires the recognition of assets and liabilities, which are not the subject of invoices or other prime records (for example, the recognition of provisions, impairment of assets, and deferred tax). They also have difficulty identifying intra-group transactions as their identification was unnecessary in the past because of either the focus on legal entity financial statements or the lack of group structures. The difficulties are compounded when companies undertake business deals outside their normal operating procedures. Companies are also less able or willing to cope with the identification of information required for related party disclosures as well as the other extensive disclosures required by IFRS.

67. **There is a shortage of internationally recognized expertise on the valuation of property, plant and equipment, which brings into question the reliability of valuations used on privatizations, business combinations and other non-cash transactions.** It is understood that there are only two valuation firms in Kazakhstan which employ valuers with internationally recognized qualifications. Many local valuers do not have such qualifications and allow different valuation bases, with the result that some audit firms are unwilling to rely on their valuations. This has led to a qualified audit opinion on the IFRS financial statements of one company. It is likely to lead to significant difficulties on the further use of IFRS starting 2006, which require

¹⁵ All financial statements in the sample are audited by local member firms of international audit firm networks with the exception of one set of financial statements, which was audited by the United Kingdom member firm of an international audit firm network. Ten audit reports were unqualified (one included an emphasis of a matter paragraph) and one was qualified.

¹⁶ Five sets of financial statements in the sample are audited by local member firms of international audit firm networks and nine sets by local audit firms. Ten audit reports were unqualified and four were qualified. Also, 10 audits were conducted in accordance with Kazakh Standards on Auditing and four in accordance with ISA.

reliable valuations for some transactions. It is also likely to cause difficulties on the transition from KAS to IFRS for those companies that are unable to calculate the IFRS carrying amount of PPE.

68. **While most IFRS consolidated financial statements of the enterprise sector entities and banks in the sample appeared to comply with IFRS, the assessment identified several areas of potential non-compliance, which could have a material effect on the financial statements.** The assessment points to a number of areas where compliance in form rather than substance appears to be accepted by preparers and auditors, including the following:

- ***Determination of fair values of some financial assets and financial liabilities:*** A number of bank financial statements set forth that “the lack of liquidity in the Kazakhstan market means that it is not possible to determine the fair value of all financial assets and financial liabilities.” Hence, these banks concluded that the “fair values of trading and investment securities are not materially different from their carrying values.” During discussion with management, the ROSC team noted that bank management and auditors had little evidence to support this assertion, which raises concerns about the carrying value of these assets and liabilities.
- ***Impairment of financial assets:*** The application of IAS 39, *Financial Instruments: Recognition and Measurement*, may be influenced by the requirements of the banking regulator. While the notes to the financial statements rightly set out that “... for the purpose of measuring the allowance for loan losses, the recoverable amount of loans is measured at the present value of the expected future cash flows,” bank management was often unaware of the measurement policy set forth in the notes to their financial statements. Also, certain financial statements set out that “loans are placed on non-accrual status when interest or principal is overdue for more than 30 days except when all amounts are fully secured,” which may be contradictory to the use of a discounted cash flow measurement policy (refer to IAS 39, Application Guidance (AG), Section 93). The accounting policies and discussions with management bring into question the application of the effective interest rate method under IAS 39.
- ***Investments in other entities in which the company owns less than the majority interest and which are not subsidiaries, joint ventures or associates:*** A company measured these investments at cost although such investments should be measured at fair value in accordance with IAS 39. In the absence of a disclosure regarding the fair value of these investments, the ROSC team was unable to assess the materiality of such non-compliance.
- ***Government grants including the measurement of PPE contributed by Government:*** The ROSC team noted an instance where rights and licenses acquired by a company were contributed to share capital of associates and subsequently revalued at fair value. The notes to the financial statements are confusing in several respects, e.g. from whom did the company acquire the rights and licenses and at what price; how, and by whom, were the rights and licenses contributed to the share capital of the associates; why were they revalued; does the revaluation comply with the fair value model in IAS 38, *Intangible Assets*, in particular is there an active market for these rights and licenses. In the absence of such information, external users may not have adequate information to appraise the privatization process or to make informed decisions with regard to the company.
- ***Revaluation of rights and licenses and PPE:*** The ROSC team noted the following disclosure: “buildings are revalued with sufficient regularities such that the carrying

amount does not fluctuate materially.” This is a worrying statement (but may be a translation error), which raises concerns about the thoroughness of the preparer’s and auditor’s quality control procedures.

- **Acquisition accounting including the measurement of acquired assets and liabilities:** Several companies reported PPE, which is measured on recognition at cost and is subsequently revalued using “capital assets coefficient cost increases determined by the State Committee of Kazakhstan on Statistics and Analysis.” Auditors qualify their opinion with respect to the amounts attributed to such assets on their acquisition as part of the acquisition of former state controlled entities and, hence, the amounts attributed to goodwill/negative goodwill. This qualification appears appropriate and its effect cannot, by definition, be quantified.
- **Pension accounting including the possible existence of defined benefit plans:** For example, while the legal requirements for pensions disclosed in the financial statements imply that a sample company has a defined benefit obligation, the accounting policy implies that defined contribution plan accounting is used.
- **Components of cash and cash equivalents in the cash flow statement:** Several companies include time deposits “irrespective of when the deposits mature” under “cash and cash equivalents” in the cash flow statement. This conflicts with IAS 7, *Cash Flow Statements*, which requires a three month limit. Furthermore, some of the time deposits are restricted as to their use as they are being held as collateral or guarantees. Such deposits should probably be excluded from cash and cash equivalents.
- **Disclosures about related party transactions:** A company acquired a subsidiary for US\$5.5 million in 2004. At the date of acquisition, the subsidiary had an interest free loan of US\$5.3 million payable to Company ABC. The loan was measured at US\$5.3 million, which would appear to exceed its fair value and, therefore, understate the fair value of the net assets acquired. The loan was repaid in 2004. The transaction does, in any event, appear to be a related party transaction. It is not disclosed as such in the notes to the financial statements.

69. **The quality of KAS-based financial statements was generally very weak, with a number of significant non-compliance issues.** These issues are so significant that, in most instances, users of these financial statements would be unable to make an informed decision on their basis or, worse, could be misled in their decision-making process. The issues noted included:¹⁷

- **Non-compliance with KAS 30, Presentation of Financial Statements:** In eight sets of audited financial statements, the format of the financial statements differed materially from the requirements of KAS. For example, in all these cases, the financial statements did not include accounting policies, which makes it very difficult for a user to understand the financial statements. Also, in two instances, the numbers on the face of the balance sheet and income statement differed materially from the numbers disclosed in the notes.
- **Cash flow statement materially misstated:** In four sets of audited financial statements, the cash flow statement did not reconcile with the balance sheet and income statement. In one company, an acquisition of assets representing 34% of the total balance sheet was not reflected in the cash flow statement. In another company, a sale of financial assets worth

¹⁷ The ROSC team decided to report only on issues that were deemed material and beyond doubt. Hence, several possible non-compliance issues are not reported on in this report, when the ROSC team was unable to conclude without question as to the nature and materiality of the non-compliance.

1.6 billion Tenge (equivalent of approximately US\$12.3 million) was not reflected the cash flow statement.

- **Fundamental error in investment in subsidiary/associate:** In one instance, a sample company reported owning one hundred per cent of the shares of a subsidiary (company ABC) as at December 31, 2004, while another company in the sample also reported holding 49% of the shares of Company ABC at the same date. While the review was unable to conclude as to which of the two companies in the sample erroneously reported owning Company ABC, this error is extremely damaging to the credibility of audited financial statements.
- **Misleading information or lack of information on related parties:** In two instances, information on related parties was misleading and, in several instances, it appeared to be lacking.

IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

70. **Although the new Audit Law requires the use of ISA from May 2006, until that date Kazakh Standards on Auditing (KSA) were in force. Many auditors are familiar with KSA and not with ISA. Thus this section analyzes the differences between KSA and ISA. While KSA were inspired by ISA, they fall significantly short of ISA.** As discussed in Paragraph 50 above, only 11 KSA have been approved by the Ministry of Finance as summarized in the table below.

KSA	ISA Equivalent
KSA 1, <i>Objective and General Principles Governing an Audit of Financial Statements</i>	ISA 200, <i>Objective and General Principles Governing an Audit of Financial Statements</i>
KSA 2, <i>Terms of Audit Engagements</i>	ISA 210, <i>Terms of Audit Engagements</i>
KSA 3, <i>Quality Control for Audit Work</i>	ISA 220, <i>Quality Control for Audit Work</i>
KSA 4, <i>Documentation</i>	ISA 220, <i>Documentation</i>
KSA 5, <i>The Auditor's Report on Financial Statements</i>	ISA 700, <i>The Auditor's Report on Financial Statements</i>
KSA 7, <i>Planning</i>	ISA 300, <i>Planning</i>
KSA 8, <i>Knowledge of the Business</i>	ISA 310, <i>Knowledge of the Business</i>
KSA 9, <i>Risk Assessments and Internal Control</i>	ISA 400, <i>Risk Assessment and Internal Control</i>
KSA 10, <i>Audit Evidence</i>	ISA 500, <i>Audit Evidence</i>
KSA 11, <i>Initial Engagements – Opening Balances</i>	ISA 510, <i>Initial Engagements – Opening Balances</i>
KSA 12, <i>Management Representations</i>	ISA 580, <i>Management Representations</i>

This results in significant differences due to two primary reasons:

- the equivalent ISA may have been revised since the KSA was adopted (e.g., ISA 700 was revised and gave rise to conforming amendments in ISA 200, ISA 210, etc.); and
- ISAs include more than 20 standards and 15 practice statements, which do not have an equivalent in KSA (refer to Paragraph 71 below).

71. **The differences between KSA and ISA are such that an audit performed in accordance with KSA is likely to provide a lot less assurance than an audit performed in accordance with ISA.** The most significant differences arise from the lack of a KSA equivalent for more than 20 ISAs, including:

- **Audit Materiality:** Under ISA, the objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. Information is “material” if its omission or misstatement could influence the economic

decisions of users taken on the basis of the financial statements. ISA 320, *Audit Materiality*, requires that an auditor considers materiality when: (a) determining the nature, timing and extent of audit procedures; and (b) evaluating the effect of misstatements and in evaluating whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. KSA does not include such a requirement, which may (i) lead to the auditor to fail to identify the inclusion of information, which is materially incorrect or the omission of material information thus undermining the reliability of the financial statements, or (ii) give the impression to users of financial statements that the auditor reviews each and every transaction.

- ***Auditor's responsibility to consider fraud in an audit of financial statements:*** ISA 240, *The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements* distinguishes fraud from error and describes the two types of fraud that are relevant to the auditor. These two types of fraud are (a) misstatements resulting from misappropriation of assets; and (b) misstatements resulting from fraudulent financial reporting. These procedures are needed to ensure that the risk of a material fraud remaining undetected by the audit is minimized. There is no equivalent requirement in KSA.
- ***Analytical procedures or audit sampling and other means of testing:*** ISA 520, *Analytical Procedures*, requires that the auditor apply analytical procedures as risk assessment procedures to obtain an understanding of the entity and its environment and in the overall review at the end of the audit. There is no equivalent requirement in KSA.
- ***Related parties:*** ISA 550, *Related Parties*, requires that the auditor perform audit procedures designed to obtain sufficient appropriate audit evidence regarding the identification and disclosure by management of related parties and the effect of related party transactions that are material to the financial statements. There is no equivalent requirement in KSA.
- ***Audit of Fair Value:*** In many cases, IFRS requires or permits the use of fair value when measuring the value of assets and liabilities. ISA 545, *Auditing Fair Value Measurements and Disclosures*, requires that as part of the understanding of the entity and its environment, including its internal control, the auditor should obtain an understanding of the entity's process for determining fair value measurements and disclosures and of the relevant control activities sufficient to identify and assess the risks of material misstatement at the assertion level and to design and perform further audit procedures which are described by the standard. There is no equivalent requirement in KSA.

72. **The quality of statutory audits is uneven.** From the review of audited financial statements (refer to Paragraph 64 above) and discussions conducted by the ROSC team with sole practitioners, small and large audit firms, and the COA, specific issues surfaced that adversely impact the average quality of auditing practices in Kazakhstan:

- ***The local member firms of international audit firm networks appear to use more in-depth audit procedures and assign more experienced personnel when auditing IFRS financial statements than when auditing KAS-based financial statements¹⁸.*** While this is not an issue specific to Kazakhstan, observers fear that this may adversely affect the quality of audits of KAS-based financial statements.
- ***The local member firms of international audit firm networks appear to use more in-depth audit procedures and assign more experience personnel when auditing***

¹⁸ The local member firms of international audit firm networks purport to use the same risk based audit approach to KAS financial statements and IFRS financial statements in terms of auditing standards, personnel and review procedures.

IFRS financial statements of companies raising debt or equity financing abroad. While the local member firms of international audit firm networks carry out extensive quality control procedures of IFRS financial statements, including their review by technical experts in Moscow and, sometimes, London or Frankfurt, these procedures do not appear to be applied systematically in the absence of foreign regulatory scrutiny and/or exposure to auditor's liability.

- ***A significant number of audit reports prepared by local audit firms were so poor as to preclude a user of these audited financial statements to reach any conclusion about the work undertaken by the audit firm.*** Eight out of 14 audit reports reviewed by the ROSC team had either no addressee, did not identify the financial statements they were related to, included a reference to a company other than the one whose financial statements were attached to the audit report, included a reference to accounting standards in lieu of auditing standards, etc.
- ***A number of audit reports prepared by local audit firms were complacent, giving rise to significant concerns as to compliance with the Code of Ethics, including independence.*** Four out of 14 audit reports reviewed by the ROSC team should have been qualified for material and obvious departures from KAS.
- ***A number of audit reports prepared by local audit firms were based on insufficient audit procedures and give rise to significant concerns as to compliance with KSA and audit quality.*** Three out of 14 audit reports reviewed by the ROSC team included an appendix setting forth the audit procedures undertaken by the audit firm. In those three instances, the ROSC team noted that the audit firm expressed an unqualified audit opinion although:
 - The audit firm had not observed the inventory count and had not observed the physical existence of property, plant, and equipment (the company was in its first year of activity), representing 23% of the total assets, but solely relied on invoices and accounting registers. The ROSC team noted similar issues in two other audits.
 - The audit firm had not requested external confirmations for “advances paid” representing 62% of the total assets. The evidence gathered by the auditor appeared to be internal documents only, which may not comply with audit requirements. The ROSC team noted a similar issue in one other audit.

V. PERCEPTIONS OF THE QUALITY OF FINANCIAL REPORTING

73. **The overall perception of the ROSC team was that the quality of financial reporting in Kazakhstan can be divided into two categories and closely linked to the perception of the company's audit firm and the accounting standards applied:**

- The market perceives that the companies that are audited by the local member firms of international audit firm networks have good quality financial information, generally compliant with IFRS. These companies have the ability and either the obligation or an interest in paying the price required to obtain a quality audit. As discussed in Section III, the review of a sample of audited IFRS financial statements partially confirms market perception although it raises concerns about whether IFRS compliance “in form” rather than “in substance” does not sometimes take precedence.
- The market perceives that other companies, which prepare financial statements under KAS and/or are audited by sole practitioners or audit firms, which are not members of international audit firm networks, tend to have lower quality financial information.

Most of these companies are only obtaining audit opinions to meet their legal obligations and desire the lowest possible audit fee for which they generally expect no substantial audit work to be done in return. Section III confirms market perception in this regard.

However, the market perceives a gradual improvement in audit quality following the introduction of CAP/CIPA examinations as a basis for auditors' certification by the QC (refer to Section II.C). Market participants have, on several occasions, pointed to the license number of the statutory auditor signing the audit report as an indicator of the auditor's competence. Since license numbers are sequential, market participants take due note of the auditor's license number and regard licenses issued after the introduction of the CAP/CIPA examinations as generally more trustworthy than earlier licenses.

74. **This situation is exacerbated by the fact that general purpose financial statements are not generally perceived as useful by the significant users of financial information, giving little incentive to enterprises to improve the quality of their general purpose financial statements.** Examples of such lack of interest are:

- The AFS tends to rely on prudential reporting in its supervision and little effort has been directed towards ensuring compliance with IFRS. However, the quality of financial statements of regulated enterprises tends to be higher, since they are more likely to employ the services of audit firms that are part of international audit firm networks.
- Banks predominantly undertake collateral-based lending and therefore have a tendency to be more concerned with the existence and value of secured assets rather than the financial statements of the enterprises to which they lend.
- The tax authorities are interested only in financial information based on the provisions of the Tax Code leading to firms designing underlying data recording systems aligned to the recognition and measurement criteria embodied in the Tax Code with a restatement exercise undertaken in order to comply with IFRS/KAS in the financial statements.
- The lack of sanctions against enterprises failing to comply with accounting standards or auditors failing to comply with auditing standards creates an environment within which the general purpose financial statements tend to be regarded as irrelevant.

VI. POLICY RECOMMENDATIONS

75. **The principal objective of this ROSC assessment is to assist the authorities and other stakeholders in strengthening the corporate sector's accounting, financial reporting and auditing practices, as a means to facilitate the President's goal of successfully integrating Kazakhstan into the global economy. Implementation of these recommendations will help in:**

- Enhancing the business climate and bolstering domestic and foreign direct and portfolio investment in the private sector;
- Stimulating growth in the SME sector by facilitating the SMEs access to credit from the formal financial sector by shifting gradually from collateral-based lending decisions to lending decisions based on the financial performance of the prospective borrower;

- Supporting the stability of the banking sector and mitigating the risk of crises due to loan collection problems and helping mobilize domestic savings; and
- Achieving greater financial transparency in the corporate sector, both State and private-owned, thus allowing shareholders and the public at large to assess management performance and influence its behavior.

Without attempting to provide a detailed tactical design for reforms, this report sketches the policy recommendations to support the implementation of accounting reform and ultimately enhance the quality of corporate financial reporting.

76. **The recommendations of this ROSC are interrelated and mutually supportive, designed to collectively improve the financial reporting environment in Kazakhstan.** For example, superb accounting standards are jeopardized at the beginning if people do not understand how to translate the standards into journal entries and a rigorous statutory and regulatory framework is unlikely to be effective if it is not enforced. Additionally, as illustrated in Figure 1 in the Executive Summary, some recommendations will not have an immediate effect but are still high priority if the financial reporting environment in Kazakhstan is to be upgraded to the level of developed economies within a reasonable timeframe.

77. **Accordingly, with regard to the Statutory Framework we recommend the introduction of:**

- A requirement for legal entity and/or consolidated financial statements to be audited only when there is a public interest for such an audit irrespective of the entity’s legal form. However, should these requirements still result in a situation where the number of audits required by law is excessive as compared to the availability of qualified auditors in the market, policymakers should phase in these requirements with a view to ensure that statutory audit requirements do not crowd out Kazakhstan’s audit capacity.
- An option to adopt the “ISA Plus” model, whereby—while ISAs are adopted in full—additional standards and audit procedures may be imposed if they follow from specific requirements relating to the scope of the statutory audit (e.g., an additional requirement for bank audits to contribute to the AFS’s prudential supervisory process).
- An amendment to the mandate of the COA to include serving the public interest, in particular with regard to the audit profession’s public, which consists of clients, credit grantors, governments, employers, employees, investors, the business and financial community, and others who rely on the objectivity and integrity of auditors.
- The establishment of a public oversight system for the Chamber of Auditors, ensuring that the audit profession does indeed serve the public interest.
- A requirement for *public interest entities* to make their audited legal entity (and consolidated) financial statements, including the notes to the financial statements, readily available to the public¹⁹ within a reasonable period after the balance sheet date.

78. **With regard to Accounting Standards we recommend that**

- The existing translation process be enhanced in order to achieve a sustainable translation process in Russian and/or Kazakh language whereby the official

¹⁹ The equivalent requirements exist in EU Member States as set forth in the Fourth and Seventh EU Company Law Directives, and the Transparency Directive.

translation of IFRS is readily available and affordable across the country. This translation process should also be leveraged in the context of the translation of International Public Sector Accounting Standards (IPSAS) and ISA (e.g., pooling resources, using a common software, etc).

- An Accounting Standards Committee or an Advisory Council made up of a wide constituency of representatives of preparers and users of financial statements be established to agree on a simplified financial reporting system for application in entities that do not meet the definition of a *public interest entity*. The current Kazakh Accounting standards could form the basis of a simplified financial reporting regime for SMEs subject to a program of review and revision of the standards. Alternatively, Kazakhstan could review the ongoing project of the International Accounting Standards Board (IASB) on “Accounting Standards for SMEs.”
- Policymakers and regulators revisit the relationship between prudential and general purpose financial reporting in the financial sector. The introduction of IFRS is often a source of concern to supervisory authorities, notably because of fears that these standards could jeopardize the criteria that “regulatory own funds” have to fulfill, namely that they be (i) permanent, (ii) readily available for absorbing losses, and (iii) reliable as to their amounts. There are also some concerns that IFRS could introduce volatility into financial institutions’ financial statements and, more particularly, into regulatory own funds, in ways which might not reflect the economic substance of institutions’ financial positions. The NBK and the AFS should develop prudential filters for regulatory capital with a view to adjust regulatory own funds for changes appearing in the accounting equity of financial institutions applying IFRS. In this context, the NBK and the AFS could draw on the work conducted under the auspices of the Basel Committee on Banking Supervision and the Committee of European Banking Supervisors. This approach would make clear the distinction between prudential and general-purpose financial reporting. However, since the regulators would have a keen interest in ensuring that the IFRS-based financial statements are correct—since their reports would be built on that foundation—this would mobilize them to assist in the enforcement of shareholder- or stakeholder-oriented financial statements as well.
- The Ministry of Finance establishes a working group consisting of standard setters and tax administration officials to consider how to minimize the barriers to accounting reform currently resulting from the Tax Code and its administration.

79. **With regard to Auditing Standards we recommend that:**

- The existing translation process be enhanced in order to achieve a sustainable translation process into Kazakh and/or Russian language whereby the official translation of ISA is readily available and affordable across the country. This translation process should also be leveraged in the context of the translation of International Public Sector Accounting Standards (IPSAS) and IFRS (e.g., pooling resources, using a common software, etc).
- The CoA develop a standard audit methodology and audit manual for those audit practices that need support. This would allow the audit profession of Kazakhstan as a whole to improve the quality of the auditing function, which would in turn lead to an increase in public confidence in the reliability of the information contained in financial statements.

80. **With regard to the Monitoring and Enforcement of Accounting and Auditing Standards we recommend that:**

- KASE strengthens its oversight over the process of disclosing information received from listed companies on its website. The oversight unit should ensure that information received is disclosed on the KASE website in a timely and accurate manner, and all facts of non-compliance should be reported to the AFS for investigation.
- The AFS adopt internationally accepted principles of accounting standard enforcement. This report has regard to Standard No. 1, *Enforcement of Standards on Financial Information in Europe*, set forth by the Committee of European Securities Regulators (CESR) as a possible reference for the AFS. Adoption of these principles would lead to the AFS developing monitoring and enforcement procedures to ensure that the financial markets and the general public could access relevant and reliable financial information. Enforcement actions should not be confused with civil or criminal sanction, although these clearly have a role to play, and should focus on ensuring that all the required information is both materially correct and available to the market so as to promote capital market efficiency. The AFS should establish its enforcement actions so as to ensure that when there is a material error in the published financial statements corrected information is made available to the public.
- The supervisory agencies (AFS, NBK, Ministry of Finance, etc.) second key operational staff to similar agencies abroad for “on the job training” on best international practices regarding monitoring and supervision in respective areas as well as IFRS. Also, the supervisory agencies may be able to enter into twinning programs to bring experienced regulators from peer institutions to Kazakhstan to actually work with and provide on-the-job training to the best of the existing staff in the AFS, NBK, KASE, etc.
- The AFS increases its human resources by employing more staff who are familiar with IFRS. In order to fulfill its role as an accounting standard enforcement agency, the AFS should recruit additional staff with extensive knowledge and experience of IFRS. In any event, the AFS will need to develop a network and procedures to ensure that it keeps fully up to date with IFRS as it evolves.
- The AFS should seek to strengthen its relationship with statutory auditors to mutual advantage. While the objectives of supervisors and auditors are different, there are many areas where the work of the supervisors and of the external auditor can be useful to each other. The following are examples of types of other matters that may come to the attention of the auditor and may require urgent action by the supervisors:
 - a serious conflict within the decision-making bodies or the unexpected departure of a manager in a key function;
 - the intention of the auditor to resign or the removal of the auditor from office; and
 - material adverse changes in the risks of the bank’s or insurance undertaking’s business and possible risks going forward.

Also, the AFS may contemplate requiring the statutory auditor to carry out specific assignments or issue special reports to assist the supervisors in discharging their supervisory functions (e.g., reporting upon whether the systems for maintaining accounting and other records and the systems of internal control are adequate; the method used by the bank or insurance undertaking to prepare reports for the supervisors is adequate and the information included in these reports, which may

include specified ratios of assets to liabilities and other prudential requirements, is accurate; etc.). In establishing such systems, supervisors will have regard to internationally accepted guidance such as the guidance issued jointly by the Basel Committee on Banking Supervision and the International Auditing Practices Committee of IFAC in January 2002, on the “relationship between banking supervisors and banks’ external auditors.” The effectiveness of this action hinges upon organizing the relationship in law to expressly waive the auditor’s duty of confidentiality in his or her relationship with the supervisors. It also hinges upon ensuring that only duly qualified auditors are authorized to audit banks, insurance undertakings, and listed enterprises.

- The system of quality assurance of all statutory auditors and audit firms should be successfully implemented by the COA as required by the Audit Law. In addition, the system of quality assurance should be subject to public oversight. Quality assurance for the statutory audit is fundamental for ensuring good audit quality, which adds credibility to published financial information and adding value and protection to shareholders, investors, creditors and other stakeholders. The system may draw upon existing practices in EU Members States, especially countries, which joined the EU on May 1, 2004, which have had to implement quality such systems in circumstances similar, albeit not identical, to Kazakhstan’s. Also, IFAC SMO 1, Quality Assurance is a useful guideline in this regard. The results of the external quality assurance system should feed into the licensing of auditors, the Continuing Professional Development program and/or the disciplinary system, as appropriate.
- Kazakhstan should establish an effective system of investigations and sanctions to detect, correct and prevent inadequate execution of the statutory audit. The system may provide effective, proportionate and dissuasive civil, administrative or criminal penalties in respect of statutory auditors and audit firms, where statutory audits are not carried out in conformity with the Audit Law, ISAs, and/or the Code of Ethics for Professional Accountants. Also, measures taken or sanctions imposed on statutory auditors and audit firms should be appropriately disclosed to the public.

81. With regard to the Development of the Accounting and Auditing Profession we recommend that:

- Kazakhstan recognizes high quality qualifications from abroad such as ACCA (UK) and CPA (US) for the purpose of awarding the auditor qualification. The fact that the qualifications of auditors from other countries cannot be recognized in Kazakhstan does not compare well with examples of best practice in other countries. The ROSC team believes that it serves no purpose to require complete re-examination when the necessary expertise already has been proved.
- Kazakhstan simplifies visa and work permit requirements for suitably qualified foreign specialists, who may fill the current capacity gap in the accounting, auditing, insurance, banking and other professions.
- The COA should establish a public electronic register of statutory auditors and audit firms so that interested parties can determine rapidly whether a statutory auditor or an audit firm has been approved, etc. This will be facilitated through registration in a public electronic register. Availability of the public register in foreign language would greatly increase its usefulness especially in the context of foreign direct or portfolio investment.

- The capacity of the COA should be increased so as to enable it to make a more effective contribution to the audit profession in Kazakhstan. In particular it should be resourced so as it could
 - Operate a technical advice help desk for members;
 - Produce and distribute an audit manual for small audit firms; and
 - Develop a standard audit methodology and audit program pack for small audit firms.
- A detailed review of required activities of the COA and a twinning arrangement with a respected professional body should be considered.
- Kazakhstan adopts a sequential approach to the qualification of accountants and auditors, instead of the present parallel approach. The first step should be to intensify cooperation in the assessment of CAP/CIPA modules for the separate qualifications of accountants and auditors. The ideal would be mutual recognition of the results. The second step would be the design and implementation of a sequential system as follows. The present CIPA qualification could become the entrance requirement for the auditor qualification. This would mean that potential auditors who qualified as CIPA have already passed all the CIPA examinations and have three years of relevant practical experience. To become an auditor two additional requirements would have to be fulfilled:
 - passing of an auditor examination under responsibility of the QC; and
 - Acquiring two additional years of practical experience in an audit environment.

The auditor examination could either be modular or integral. The final proof of professional competence should only be taken after the period of additional practical experience.

- Practical Experience should be brought in line with IFAC requirements. Mentorship and supervision have to be promoted. It is necessary to review the present Kazakh requirements for Practical Experience and to bring them in line with IES 5.

82. **With regard to Education and Training we recommend that:**

- Starting from the present situation, emphasis should be given to developing an educational continuum from university through to the continuing professional development of accounting and auditing professionals encompassing the requirements of the IFAC IESs.
- The further development of the university curriculum should include more emphasis on IFRS financial reporting and the organizational and business knowledge component of IES 2. CAP/CIPA program materials have already been made available and some teachers have been trained. This probably is not enough, as universities face a shortage of expertise in certain areas and more teaching and learning material in Russian or Kazakh is needed. The university curriculum will need to include economics, business environment, corporate governance, business ethics, financial markets, quantitative methods, organizational behavior, management and strategic decision making, etc. Universities will need to work closely with the professional bodies and the accounting profession to develop degree programs appropriate to the developing needs of the business community. Examples of necessary external support that were mentioned included benchmarking of existing material against best examples of literature in the English language, continuing support of training for teachers and assistance with translations.

- The existing CAP/CIPA examination should be retained as the basis for qualification as a professional accountant and membership of CPAA. However, this examination should be augmented by structured practical experience as required by IES 5. Full membership of CPAA should not be conferred on candidates until such time as they have fulfilled the practical experience requirements.
- The CPAA should ensure that the practical experience gained by candidates is acceptable. Candidates should be assigned to a suitably qualified individual as a “mentor” and records kept of experience gained for inspection by the CPAA prior to certification as a professional accountant.
- The COA should address the requirements of IES 8, where professional auditors are required to have an advanced level of knowledge regarding financial reporting and auditing. In this respect, the CIPA qualification should be retained as the entrance requirement for the audit profession, with assessment of individuals’ demonstration of professional knowledge, skills and values, ethics and attitudes required to competently perform the work of audit professionals. This will require the introduction of a new examination to be taken in addition to the CAP/CIPA program.
- The COA should also ensure that candidates for the audit qualification receive sufficient and relevant practical experience prior to the award of the qualification. Therefore, the COA should establish an associate membership for candidates for the audit examination so that practical experience can be both structured and monitored in line with both IES 8 and IES 5.
- Having established a robust basis for qualification, it is essential that continued membership of both the CPAA and the COA is dependent on completing a minimum level of CPD. Such CPD needs to be monitored by the professional bodies to ensure that all members remain up to date with the developments in accounting and auditing standards and practices. It is important in this respect that the professional bodies develop and promote appropriate CPD courses and materials.
- Kazakhstan should also establish a mechanism to educate accountants and auditors who are in situ at Kazakh companies to improve practical application of modern accounting and auditing. Leveraging the practical experience of established accountants and auditors is of paramount importance, which calls for the adoption of incentives to give them the opportunity to improve their understanding of IFRS and ISA and their application to their work within the financial reporting framework in Kazakhstan.

On the demand side, policymakers could incentivize company management to invest in such retooling through a combination of positive (e.g., education tax credits) and deterrent incentives (e.g., liability for the probity of financial statements). In the context of SOEs, the State, acting as a shareholder, could take the lead and ensure that accountants in SOEs enroll in “retooling” programs.

On the supply side, private sector accountancy education centers could also be incentivized to open in Kazakhstan through specific measures. Their offering should however be tailored to the needs of Kazakh companies. In most Kazakh companies, much of the finer detail of IFRS will be irrelevant. The core concepts, such as the accrual basis, the separation of tax and financial reporting, and the interaction of financial statements, management accounting and cash flow accounting, should be central to the education of the profession.

Appendix: Accounting Standard Monitoring and Enforcement
Benchmarking against CESR Standard No. 1, Enforcement of Standards on Financial
Information in Europe

Standard No. 1, *Enforcement of Standards on Financial Information in Europe*, set forth by the Committee of European Securities Regulators (CESR) is a possible reference for the AFS. Standard No. 1 on Financial Information sets out 21 fundamental principles of enforcement considered by the European Securities Regulators as essential for furthering the objectives of investor protection and the integrity and transparency of financial markets. This Appendix provides a principle-by-principle assessment against Standard No. 1:

- *Principle 1 – The purpose of enforcement of standards on financial information providers by the issuers mentioned by principle 9²⁰ is to protect investors and promote market confidence by contributing to transparency of financial information relevant to the investors’ decision making process.* This is consistent with the aim of the AFS, established in 2004, which has a department dedicated to the supervision of the securities market.
- *Principle 2 – Enforcement is defined as monitoring compliance of the financial information with the applicable reporting framework and taking appropriate measures in case of infringements discovered in the course of enforcement.* Currently the appears to be little monitoring of compliance with IFRS within the published financial statements with greater emphasis placed on administrative issues such as late filing resulting, in some cases, in a lack of appropriate information being available for investors.
- *Principle 3 – Competent independent authorities should have the ultimate responsibility for enforcement of compliance of the financial information provided by issuers.* The establishment of the AFS establishes an appropriate independent authority, which has been structured so as to ensure there is a department dedicated to the supervision of the regulated securities market.
- *Principle 4 – Other bodies might carry out enforcement on behalf of the competent administrative authorities, provided that these bodies are supervised by and responsible to the relevant competent administrative authority.* Under this principle it would be possible for the KASE to monitor compliance with IFRS, however, the investigations of the ROSC team found instances of non-compliant financial information being accepted without question by the KASE.
- *Principle 5 – Irrespective of who carries out enforcement any standard on enforcement established by CESR should be complied with.* The AFS is charged with the prudential supervision of banks, insurance companies, pension funds and the securities market.

Prudential supervision has been the main focus of the AFS until now, as is to be expected in such a new organization. The AFS also plays a significant role in consumer protection with a significant effort directed towards the investigation of complaints by the public. Considering the minimum powers and characteristics required by CESR Standard No. 1, the AFS has a positive impact in respect of the monitoring and enforcement of financial information required in respect of the financial statements of banks, insurance companies and pension funds.

However, given the nature of the culture of regulation within Kazakhstan, any improvements in the quality of financial reporting that the AFS may bring about appear to be a by-product of its prudential supervisory responsibilities. Standard No. 1 makes clear, for example, that the request for further information from auditors and

²⁰ Reference to principle 9 indicates that the scope of the standard covers the financial information of entities whose securities are traded on a regulated market.

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management must be made with the aim of enforcing the reporting framework for financial information. The procedures the AFS instigate in respect of breaches of the standards and limits specified by the Banking Law are sanctions imposed by national legislation designed to penalize. Actions as described in Standard No. 1 are “measures generally aimed at improving market integrity and confidence.”

- *Principle 6 – Competent administrative authorities shall have adequate independence from Government, and market participants, possessing the necessary powers and having sufficient resources.* The establishment of the AFS is part of the policy to establish an independent and effective system of state regulation of the financial market. The resources available to the AFS appear adequate given the current size of the financial market and it has the power to obtain such information as it requires in order to fulfill its functions. However, there is a lack of IFRS qualified staff, which makes the specific task of monitoring compliance with IFRS difficult.
- *Principle 7 – The necessary powers, which may be delegated to those acting on behalf of the competent independent administrative authority, should at least include the power to monitor financial information, require supplementary information from issuers and auditors and take measures consistent with the purposes of enforcement.* It would appear that the necessary powers are available to the AFS but that compliance with accounting standards has not as yet been prioritized by the agency.
- *Principle 8 – The competent administrative authorities should be responsible for (a) the setting up of an appropriate due process of enforcement consistent with the application of the principles hereby stated; and (b) the implementation of that due process.* It is clear that with regard to prudential reporting the AFS has developed and implemented a due process for enforcement and this is evidenced by the action undertaken during 2004.²¹ Similar processes need to be established regarding the monitoring and enforcement of compliance with IFRS in the general purpose financial statements of regulated enterprises.
- *Principle 9 – The principles of enforcement should apply to financial information provided by issuers (a) whose securities are admitted to trading on a regulated market; and (b) that applied for admission to trading of their securities on a regulated market.* There is clear evidence in the financial information provided by those organizations seeking admission to trading is scrutinized but scrutiny of financial information supplied by issuers subsequent to admission to the market is less rigorously applied.
- *Principle 10 – The principles of enforcement should apply to financial information provided by all harmonized documents, including annual and interim financial statements and reports, prepared on individual and consolidated bases as well as prospectuses and equivalent documents.* Adherence to this principle will require extending monitoring procedures at the AFS to cover listed companies annual and interim financial statements.
- *Principle 11 – For financial information other than prospectuses ex-post enforcement is the normal procedure, even if pre-clearance is not precluded.* In some cases, for example when a company is the first to use a particular type of financial instrument, it may be appropriate for a listed company to seek pre-clearance for particular accounting treatments or disclosure. As covered by Principle 20 below, the

²¹ Information regarding the monitoring and supervisory actions of AFS can be found in its Annual Report.

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AFS should not drift de-facto into the position of giving general application guidance on IFRS as its role is to monitor compliance with reporting requirements rather than establish what those reporting requirements should be. Adherence to this principle will mean that information supplied by a listed company should be subject to the monitoring procedures after it has been issued, irrespective of any pre-clearance previously given by the AFS.

- *Principle 12 – For prospectuses ex-ante approval is the normal procedure. Ex-post enforcement of financial information provided by prospectuses is possible as a supplementary measure.* As previously noted the Law on Securities Market requires that all financial information included in financial statements must be made available to any interested party. The ROSC team found that ex-ante approval of prospectuses was consistently carried out by the AFS. However, the ROSC team did not form an opinion as to the thoroughness of AFS’s review.
- *Principle 13 – Enforcement of all financial information is normally based on selection of issuers and documents to be examined. However, an approach solely based on risk may be an acceptable selection method.* Adherence to this principle involves establishing a system of examining financial information so as to ensure compliance across all listed companies and therefore it would be normal to examine documents of companies even when there was no suggestion that of any non-compliance. However, given the lack of IFRS qualified staff at the current time an approach that concentrated on those companies where the risk of non-compliance was highest would be acceptable. In the first instance it would be sensible to ensure that all companies that had qualified auditor’s reports be investigated so that material non-compliance with IFRS in the information available to the public could be rectified.
- *Principle 14 – In order to allow enforcers to adopt gradually the selection methods provided for by Principle 13, a mixed selection technique based on a combination of a random selection and rotation is considered a workable transitional step. However, such a methodology should be designed to give an adequate level of detection risk.* As outlined under Principle 13 above, a screening mechanism for qualified audit reports should be a high priority for the AFS to ensure that enforcement action is taken in respect of issuers that do not prepare financial statements in accordance with the relevant requirements. However, it is important that a random element of selection be included in the selection procedures so as to promote public confidence in the system as a whole and so as to ensure that the financial statements submitted with an unqualified auditor’s report do indeed fully comply with IFRS and other statutory requirements.
- *Principle 15 – Methods of enforcement on selected information cover a wide spectrum of possible checking procedures, ranging from pure formal checks to in-depth substantive in-nature checking. The level of risk should normally determine the intensity of the review performed by the enforcers. The type of document to be examined and the level of information available on the issuer are also taken into account.* The evidence regarding compliance with regulations relating to the provision of financial information by listed companies shows that there is currently an unacceptable high level of non-compliance. Therefore, in the short term the provision of information could be significantly improved by a review of information made available on the KASE website and enforcement action to ensure that all required information is made available.

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- *Principle 16 – Where a material misstatement in the financial information is detected enforcers should take appropriate actions to achieve an appropriate disclosure and where relevant, public correction of misstatement (in line with the requirements of the reporting framework). Non-material departures from the reporting framework will not normally trigger public correction even though they normally deserve an action as well. Materiality should be assessed according to the relevant reporting framework. Information is considered material if its omission or restatement could influence the decisions made by users of the financial statements. The AFS should establish its enforcement actions so as to ensure that when there is a material error in the published financial statements corrective information is made available to the public. Non-material errors identified can be communicated and/or discussed with the company concerned but it would be inappropriate to expend scarce resources on matters that in the end do not impact on decisions and thus has no adverse effect on the securities market. However, matters such as failure to make the notes to the financial statements available to the public, as was the case for nearly 25% of listed companies in 2004, is highly material as these notes contain disclosures considered essential to fully understand the financial statements and thus the financial position and performance of the issuing company.*
- *Principle 17 – Actions taken by the enforcers should be distinguished from sanctions imposed by the national legislation. The imposition of fines on companies or individuals punishes those companies and individuals for non-compliance with the laws and regulations but does nothing to correct or improve the information available to the market. The primary role of the enforcer should be to ensure that all the required information both materially correct and available to the market so as to promote capital market efficiency. This does not mean that fines or other sanctions are inappropriate but rather that the enforcer should prioritize taking remedial action to ensure that the market is supplied with the information to which it is entitled. This is not yet the case in Kazakhstan.*
- *Principle 18 - Actions should be effective, timely enacted and proportional to the impact of the detected infringement. As noted above the enforcement measures taken by the AFS should be aimed at improving the quality of information available to the market. Given that the ROSC mission was conducted in November 2005 and that we found serious shortcoming in the information available relating to 2004 indicates that the current enforcement measures are neither effective nor timely.*
- *Principle 19 – A consistent policy of actions should be developed, whereby similar actions are adopted where similar infringements are detected. As the AFS considers the procedures it should adopt, it should also develop policies regarding how it will act in given circumstances. It would be useful if these policies were published so that listed companies become aware that compliance with IFRS and other reporting requirements relating to annual and interim financial statements are now part of the monitoring activities. This in itself may act as an incentive to improve compliance.*
- *Principle 20 – In order to promote harmonization of enforcement practices and to ensure a consistent approach of the enforcers to the application of IFRS, coordination on ex-ante and ex-post decisions taken by the authorities will take place. Material controversial accounting issues will be conveyed to the bodies responsible for standard setting or interpretation. No general application guidance in IFRS will be issued by the enforcers. It is vital that the AFS keeps abreast of developments in IFRS interpretations issued by International Financial Reporting*

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Interpretations Committee (IFRIC). It should also monitor the enforcement development in other countries, especially in the context of cross-border listings.

- *Principle 21 – Enforcers should periodically report to the public on their activities at least information on the enforcement policies adopted and decisions taken in individual cases including accounting and disclosure matters.* The AFS has instituted an annual report, which contains a significant amount of information regarding its activities. The sections dedicated to activities in the securities market should be expanded to include information regarding enforcement of IFRS and other reporting requirements of listed companies.