IMPLEMENTATION OF INTERNATIONAL ACCOUNTING AND AUDITING STANDARDS

Lessons Learned from the World Bank’s Accounting and Auditing ROSC Program

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ACRONYMS

A&A	Accounting and Auditing
EU	European Union
FoF	Forum of Firms
FSAP	Financial Sector Assessment Program
IAASB	International Auditing and Assurance Standards Board
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
ISA	International Standards on Auditing
ROSC	Report on the Observance of Standards and Codes

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EXECUTIVE SUMMARY

This paper addresses challenges to the successful implementation of international accounting and auditing standards which have been observed by the World Bank when carrying out the Report on the Observance of Standards and Codes (ROSC) accounting and auditing assessments.[****] It describes the ROSC program, outlines the methodological approach followed, identifies problems common across several jurisdictions, and makes suggestions for initiatives that could enhance the implementation of international standards. At present, the ROSC accounting and auditing assessments are undertaken in client countries of the World Bank. The results presented herein therefore do not purport to be reflective of the issues in developed market economies. It is arguably the case that before the recent accounting scandals in Europe and the United States, these issues were regarded, not least outside Europe and the United States, as unique to developing markets; after the accounting scandals, these issues are regarded as major causes of those financial scandals.

A full and balanced combination of capacity and institutionalized incentives for the rigorous application of international accounting and auditing standards incentives (both positive and deterrent) is the key to successful implementation of these standards. The ROSC results show that governments have primarily concentrated on adopting legislation mandating or allowing the use of international standards, and the

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[****] This Paper is based on a presentation at the Conference on "Challenges associated with the Implementation of International Accounting & Auditing Standards" held on October 15, 2004, at the Financial Stability Forum in Basel, Switzerland and on a presentation at the Conference on "Practical Implementation Challenges of IFRS" held on October 26, 2004 at the United Nations Conference on Trade and Development in Geneva, Switzerland. The findings, interpretations, and conclusions expressed herein are those of the authors, and do not necessarily reflect the views of The World Bank and its affiliated organizations, or those of the Executive Directors of The World Bank or the governments they represent.

private sector has sought to increase the competence of individuals and firms to apply international standards. However, governments, for the most part, have not addressed the need to put in place proper incentives to ensure that this competence is actually applied in practice. The ROSC results and recent accounting scandals in developed economies demonstrate that legal requirements and competence alone are not enough – the commitment to deploy such competence is also essential. Market forces provide certain positive incentives to comply with high standards, but experience in both developed and developing economies suggest that countervailing disincentives operate to discourage such compliance. More emphasis should be placed on the deterrent incentives of robust monitoring and enforcement regimes to achieve a full and balanced combination of capacity and incentives.

Effective accounting and auditing regulation is required to underpin such institutionalized incentives, but international accounting and auditing standards themselves do not set out requirements as to how such effective regulation should be exercised. Guidance is not provided on how to "import" international standards into national legislative and regulatory systems, on the design and operation of appropriate regulatory frameworks, or on the interfaces with other regulatory instruments and institutions (such as those for banking and securities regulation) which could contribute to the monitoring and enforcement of international standards. As currently drafted, international accounting and auditing standards implicitly assume the existence of legal, institutional and policy conditions ("preconditions") which are often undeveloped or absent in many countries. The structure of national economies, and the role played by high-quality external financial reporting, shape the extent to which these "preconditions" present themselves, and efforts to promote the implementation of international standards need to have regard to these specificities.

International standards are not necessarily appropriate to govern all financial reporting obligations, this being especially the case with International Accounting Standards (IAS) / International Financial Reporting Standards (IFRS). There is an urgent need for the International Accounting Standards Board to specify the circumstances in which the use of "full" IAS/IFRS is appropriate, and to develop different standards that would meet the needs applicable to the users of financial statements of other entities, particularly small and medium-sized enterprises (SMEs). Many stakeholders continue to have misunderstandings with respect to the very nature of international standards, which complicates efforts to plan, define and measure progress towards successful implementation.

Lack of human and financial resources is a significant impediment to the implementation of international standards. Mobilizing the necessary resources on a sustainable, long-term basis is a major challenge.

Mechanisms for public oversight of the audit function, including the setting of auditing standards and the assurance of audit quality, are almost entirely absent in

the countries assessed to date.[1] Models recently introduced in more developed jurisdictions may not always be applicable in situations where the relative importance of the various stakeholder groups is different, and national regulators do not always have easy access to emerging international best practice and consensus.

There are inherent limitations to the extent of reliance that can be placed on the international audit firm networks and their individual national member firms to compensate for weaknesses in domestic regulatory regimes. Given the governance and management arrangements of the networks, and the fact that the networks themselves are not regulated (only their member firms are, at a national level), the main determinant of audit quality is the strength of the relevant domestic regulatory regimes, rather than network membership.

To strengthen the regulatory arrangements essential for the successful implementation of international standards, countries should give greater attention to regulatory preconditions. The relevant international organizations should work together to develop a consensus on a comprehensive framework of principles for the regulation of accounting and auditing, and to support the adoption of such a framework by the competent national authorities. Special efforts should be made to strengthen and leverage the linkages between the various standards and codes that affect the implementation of international accounting and auditing standards (these include those related to the supervision of banking, securities markets and insurance, as well as corporate governance) and to fill any gaps that remain. Such principles should explicitly consider the regulatory implications of the diversity of financial systems and market structures across countries.

The World Bank stands ready to continue working with country authorities, standard-setters, regulators, private sector stakeholders, and the relevant international organizations (particularly those represented in the Monitoring Group) to address the issues identified in this paper.

[1] While the ROSC reports generally recommend the adoption of International Standards on Auditing (ISAs) because this is a more effective means of improving auditing standards in a given country than the alternative of re-writing the existing suite of national standards, the ROSC reports recognize that some international standards still need to be revised. The World Bank is contributing to that work, including as a member of the International Auditing and Assurance Standards Board (IAASB) Consultative Advisory Group. In the meantime, the ROSC reports recommend that countries take the ISAs as the foundations for national standards and supplement them with additional requirements that are believed to be appropriate for the domestic market.

I. INTRODUCTION AND BACKGROUND

1. High quality financial reporting contributes to promoting private sector growth and reducing volatility, through: (a) strengthening countries' financial architecture and reducing the risk of financial market crises, together with their associated negative economic impacts; (b) contributing to foreign direct and portfolio investment; (c) helping to mobilize domestic savings; (d) facilitating the access of smaller-scale corporate borrowers to credit from the formal financial sector by lowering the barrier of high information and borrowing costs;[2] (e) allowing investors to evaluate corporate prospects and make informed investment and voting decisions, resulting in a lower cost of capital and a better allocation of resources; and (f) facilitating integration into global financial and capital markets.

2. Financial reporting is also a building block of a market-based monitoring of companies, which allows shareholders and the public at large to assess management performance, thus influencing its behavior.

3. High quality financial reporting also contributes to strengthening the financial discipline of Government Business Enterprises (GBEs).[3] The relative lack of capital-market related pressures on GBEs means that the shareholding Ministers need to rely on administrative monitoring procedures to hold GBE boards accountable. The general adoption of International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS) by GBEs enhances shareholding Ministers' and the public's ability to assess the extent to which a GBE is creating or eroding value.

4. High quality financial reporting may also contribute to improving the assessment and collection of taxes on corporate profits. Countries currently have fundamentally different approaches to the relationship between accounting and taxation. At one extreme (total independence), income determination for accounting purposes is completely separate from income determination for tax purposes. At the other extreme (total dependence), either financial statements are prepared in accordance with tax rules, or income determination for tax purposes is determined by the choices made in financial statements. The greater the level of dependency, the greater the importance of high-quality financial statements for the assessment and collection of taxes on corporate profits.

5. As an institution committed to the fight against poverty, the World Bank undertakes a number of activities to support the development and implementation of international accounting and auditing standards, as it recognizes the contribution that

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[2] This can be achieved by shifting gradually from collateral-based lending decisions to lending decisions which are based on the financial performance of the prospective borrower.

[3] Government Business Enterprises are defined within International Public Sector Accounting Standards, issued by the Public Sector Committee of the International Federation of Accountants (IFAC). This term generally includes State-Owned Enterprises (SOEs).

high-quality financial reporting can make to development. These activities include financial support to the relevant international standard-setting organizations; diagnostic work to benchmark countries' financial reporting standards and practices against international standards; policy advice and financial assistance to support the enhancement of these standards and practices; and participation in international discussions and initiatives aimed at strengthening the regulatory environment, both nationally and globally, in which international standards are applied.

6. This paper provides an overview of the main program of Bank diagnostic work in the field of private sector financial reporting: the Reports on the Observance of Standards and Codes (ROSC) accounting and auditing assessment. It summarizes some of the main findings of the 38 assessments that have been carried out to date, with specific reference to the challenges to the successful implementation of international accounting and auditing standards. Attention is drawn to the need for international consensus on a comprehensive framework of principles for the regulation of accounting and auditing that also addresses issues of implementation, which is not covered by existing international accounting and auditing standards. The paper concludes by raising a number of other issues to be discussed and resolved going forward, if countries are to receive the support they need to successfully implement international standards and reap their full benefits.

II. IMPEDIMENTS TO THE SUCCESSFUL IMPLEMENTATION OF INTERNATIONAL STANDARDS

7. The common themes that emerge from the ROSC findings shed light on the impediments to successful implementation of international standards, even in countries that are positively committed to the process. Some of these obstacles are inherent to the standards themselves, but most are not. Hence, this points to the need for greater focus by policymakers—both national and international—on creating the conditions and instruments for successful implementation. The sections that follow describe the most common categories of obstacles encountered.

Misunderstandings as to the nature of international standards

8. Fundamental to the implementation of international accounting and auditing standards is a clear understanding of what these standards are, what they require, and what it means to adopt them. Failing this, countries are unable to set concrete implementation targets or to measure progress in reaching those targets. The ROSC findings suggest that clarity of understanding is not universal, which helps to explain the sometimes significant gaps between prior self-assessments of compliance—such as those published by the International Accounting Standards Board (IASB) and International Federation of Accountants (IFAC)—and the ROSC results.[4] The concept of adopting

[4] For example, the International Accounting Standards Board's (IASB) "2004 International Financial Reporting Standards" states—based on information provided to the IASB by Deloitte Touche Tohmatsu (2004)—that there are 92 countries around the world that either permit or require the use of IAS/IFRS by at least some (if not all) domestically listed companies by 2007. The ROSC results

international accounting standards has been interpreted in various ways by transition countries, which may hamper rigorous and uniform application of IAS.[5] The ROSC results show, however, that the adoption of International Standards on Auditing (ISA) has been less contentious. Many transition economies have taken the ISAs as the foundations for national standards and supplemented them with additional requirements, believed to be appropriate to their domestic market. Still, some countries have adopted only selected standards or adopted ISA in force as of a particular date in the past, with no account taken of changes since then. These misunderstandings give countries, and various stakeholder groups within them, a false understanding of the actual standards gap and the true implementation challenges they face.

Illustrations[6]

Accounting Standards:

Country ABC claims that IFRS are required for all listed companies. The ROSC report shows that the law mandates the use of a translation of international accounting standards, as effective in 1999. In a number of economically significant enterprises, the differences between the then-applicable international standards and "full IAS/IFRS" had an adverse impact on the quality and transparency of financial statements.

Country XYZ claims that all consolidated financial statements must be prepared in conformity with IFRS. The ROSC report showed that Country XYZ has adopted IAS 27, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*, but failed to incorporate the body of international standards that together form IFRS. The authorities did not recognize that IAS 27 is merely one of the standards that are required when preparing consolidated financial statements. Other international accounting standards such as IAS 1, *Presentation of Financial Statements*, IAS 39, *Financial Instruments: Recognition and Measurement*, are equally important.

Auditing Standards:

Country ABC claims that ISA are required for all statutory audits. However, paramount standards such as ISA501, *Audit Evidence—Additional Considerations for Specific Items* (which covers auditing segment information), and ISA550, *Related Parties*, have not been adopted domestically.

suggest that the actual number of countries that either permit or require the use of full IAS/IFRS is much lower.

5 Some interpretations of this concept include: the adoption of "Western" book-keeping methods; one-off transformations of financial statements prepared in accordance with local standards; the development of local standards "based on" IAS/IFRS; the adoption of IAS/IFRS in force as of a particular date in the past, with no account taken of changes since then; and the adoption of a subset of IAS/IFRS (e.g., excluding interpretations, which are not endorsed and hence not effective).

6 Illustrative examples are based on actual findings described in published ROSC reports, which are available at www.worldbank.org/ifa/rosc_aa.html.

Lack of appropriate mechanisms for granting national authority to international standards

9. To be effective in a national setting, international standards require the force of law or other regulatory backing. If not, compliance becomes a matter of non-transparent discretion on the part of preparers and auditors of financial statements, outside the constraints of any regulatory framework. In such cases, the standards should more properly be considered "offshore" rather than "international." There is currently no international consensus on what mechanisms should be used to provide regulatory backing, and different countries have adopted different approaches, many of which fail to achieve their stated objective. Countries are also bound by their constitutional and administrative law, which can limit significantly their ability to impart domestic legal force to international standards issued by non-official private sector organizations. Although the accountancy profession has played a major role in the development of international standards, and in their promotion at a national level, the profession itself does not have sufficient authority to ensure their successful implementation, unless acting in a regulatory capacity derived from specific legislation.

10. For countries with a tradition of reliance on laws and regulations (rather than standards) for the fixing of accounting and auditing requirements, specific issues arise. Rather than giving authority to a continuing process of standard-setting, new statutory measures are required whenever a new international standard is enacted, or an existing international standard is amended. Typically, such changes must be gazetted in the official language of the country. Such an approach can lead to delays in keeping the body of translated and gazetted IAS/IFRS up-to-date; this approach also entails significant costs and technical difficulties of carrying out translations. At the same time, preparers are also faced with difficulties, as they wish to comply both with domestic law and with current IAS/IFRS, which may not always be perfectly aligned. When such procedures are combined with an explicit endorsement mechanism to screen individual international standards for local adoption (as in the European Union), there is the further possibility that certain IAS/IFRS may not be accepted (either in full or in part). Due attention must also be given to the political significance of introducing a mechanism that may deprive a jurisdiction of the ability to have final say over the standards to which it grants legal authority.

Illustrations

Accounting Standards:

With respect to the European Union, the European Commission publishes in the Official Journal the translations of the individual "bare" international standards into the applicable languages of all Member States. However, several issues remain with respect to the translations of IFRS, which may have an adverse impact on compliance in EU Member States:

- Certain information contained in the IASB's bound volume of IFRS has not been translated and published in the Official Journal. Such excluded information includes the

Appendices to the IAS/IFRS, which contain Application Guidance and Basis for Conclusions, which may be important to fully understand the application of, and reason for, particular IFRS.

➢ Currently, Exposure Drafts for new IFRS and Draft IFRIC Interpretations are not translated and published (and, thus, made readily available). In order to make it easier for interested stakeholders to provide input to the development of new IFRS (including IFRIC Interpretations), Exposure Drafts and Draft IFRIC Interpretations should be translated, and such translations published, at the time of release.

Auditing Standards:

In country ABC, it is not clear whether a court would hold a statutory auditor to the duty of care required by International Standards on Auditing—in cases where statutory audits are required to be conducted in accordance with ISA—since language requirements in judicial procedures before courts may require an official translation of ISA in the local language, which has yet to be published.

11. Substantially all countries that so far have been the subject of A&A ROSC assessments lay down their accounting and auditing requirements in legislation, which is applicable to the generality of companies. This differs from the tradition in the United States, for example, where state company law has usually been silent on issues of accounting and auditing, and where legal general-purpose financial reporting obligations are enshrined in federal securities requirements. Although there may be arguments in favor of instituting a special regime for publicly traded companies (for which IAS/IFRS are appropriate), care needs to be taken to avoid conflicts and overlaps. Company law is concerned with the regulation of companies and typically provides for the protection of a wide range of stakeholders; often, it also covers issues relating to corporate governance. In contrast, securities law is primarily concerned with the regulation of markets and with the protection of market participants. The mechanisms used to achieve these different policy objectives are not always aligned, and can have different impacts on how the role of accounting and auditing is shaped. Successful implementation of international standards necessitates due regard for these differences. The case may be made for requirements going beyond those contained in international standards (e.g., the concept of ISA-plus, or the addition of country-specific obligations to respond to specific audit reporting mandates).

Inconsistencies between international standards and the legal framework

12. Also fundamental to the implementation of international accounting and auditing standards is an unequivocal relationship between the legal framework (e.g., company law and securities law) and international standards. The ROSC results point to several stress areas between domestic laws and the standards, which could adversely impact compliance, as well as monitoring and enforcement efforts.

Illustrations

Accounting Standards:

In country ABC, company law does not authorize a company to account for the amount of the correction of an error retrospectively. IAS/IFRS require retrospective accounting so that the correction of an error is excluded from the determination of profit or loss for the period in which the error is discovered. Such inconsistencies result in difficulties for preparers and auditors, who may find themselves unable to comply with both domestic law and international standards.

Auditing Standards:

In country ABC, company law does not authorize a statutory auditor to disclaim his or her opinion. This conflicts with ISA, which requires an auditor to disclaim an opinion when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence.

Lack of appropriate linkages between general-purpose financial reporting and regulatory reporting

13. IAS/IFRS are standards for the preparation of general-purpose financial statements, aimed at meeting the needs of a wide range of users, but predicated on the assumption that placing primary emphasis on the needs of shareholders will result in measurement, recognition and disclosure requirements that also meet the needs of other users. However, significant other users of financial statements need not necessarily share this view, and where they have the power and authority to do so, frequently impose different special-purpose financial reporting obligations designed to meet their specific needs (e.g., reporting for taxation purposes, or reporting for prudential and supervisory purposes). Not all countries successfully manage this interface between general-purpose and regulatory reporting, and it is common to encounter cases where rules designed for the latter (e.g., on loan loss provisioning in the banking sector, or on the timing of income recognition) have an impact on the former, when a single set of financial statements is intended or required to meet both objectives. Hence, the requirements of regulatory reporting may conflict with those of IAS/IFRS, thereby precluding successful implementation. Companies may have the option of voluntarily preparing additional financial statements in which full compliance with IAS/IFRS can be achieved, but this has negative cost implications and also raises uncertainties among users as to which are the “real” figures. In addition, financial statements prepared and audited on a voluntary basis typically fall outside the scope of domestic regulatory regimes, thereby often reducing the reliance users can place on them. Progress is possible when the difference between general-purpose and special-purpose/regulatory reporting is understood, and when—instead of inserting special-purpose requirements in the rules governing general-purpose reporting—countries acknowledge the existence of parallel systems, and seek to minimize differences between them. This minimizes the incremental costs of multiple

reporting and also leverages the enforcement role of regulatory bodies with respect to general purpose financial reporting.

Illustrations

Accounting Standards:

In country ABC, banks are required to present their financial statements in conformity with national accounting regulations and IAS/IFRS. In practice, most banks purport to prepare their consolidated financial statements in conformity with IAS/IFRS, since these are required by foreign shareholders, correspondent banks, and credit-rating agencies. The national bank has issued a number of regulations relating to the determination of loan losses, which require banks to calculate impairment in the unsecured portion of loans and receivables on the basis of a provisioning matrix that specifies a range of fixed provisioning rates for the number of days a loan has been classified as nonperforming (for example, 0 percent if less than 30 days, 1 percent if 30-90 days, etc.). In preparing their IAS/IFRS financial statements, banks apply the national bank regulations, which may not always be appropriate to calculate the recoverable amount of originated loans and receivables under IAS 39, *Financial Instruments: Recognition and Measurement*. IAS 39 requires impairment or loan losses to be calculated as the difference between the asset's carrying amount and the present value of expected future cash flows, discounted at the financial instrument's original effective interest rate, which may differ significantly from the impairment or loan losses determined in conformity with the national bank regulations. The national bank does not accept the co-existence of two different reported net incomes, i.e., the net income determined in conformity with national bank regulations for purposes of prudential supervision, and net income determined in conformity with "full IAS/IFRS" for general-purpose financial statements.

Auditing Standards:

In country ABC, banks are required to prepare statutory financial statements in conformity with IFRS/IAS and prudential accounting rules, which may differ from "full IAS/IFRS requirements" (for example, with respect to loan loss provisioning, as illustrated above). Some banks elect to prepare an additional set of "full IFRS/IAS" financial statements and have them audited in accordance with ISA. However, these audits of IFRS-based financial statements fall outside the scope of the quality review system, which was established pursuant to the law on auditing, since the quality review system does not extend to "contractual" audits. It is unclear whether the users of IFRS-based financial statements understand this important distinction.

Inappropriate scope of application of international standards

14. Full IAS/IFRS are not appropriate for use by all reporting entities; full IAS/IFRS should be used unchanged as the standards for public interest entities, and separate standards should apply to other entities (the "Big GAAP/Little GAAP"[7] distinction). National standard-setters thereby become setters of "Little GAAP" until the IASB issues

[7] Generally Accepted Accounting Principles (GAAP).

a separate set of standards suitable for use by such other entities. It will be interesting to monitor the experience of national standard-setters in the EU, subsequent to the introduction of IAS/IFRS in 2005, to determine whether a national body limited to setting "Little GAAP" can continue to attract the human and financial resources necessary to do its job properly, as well as ensure that national concerns are properly considered in the IASB's standard-setting process.

15. Many countries have traditionally applied a single set of accounting requirements to all companies (or all companies using a specific legal form), irrespective of size. However, the use of IAS/IFRS as that single set of requirements has frequently led to unintended negative consequences, hindering successful implementation, as full IAS/IFRS are not appropriate for small- and medium-sized entities.[8] In such cases, the necessary capacity for proper application was often not in place, costs of compliance were disproportionate, and enforcement bodies either did not exist or were unable to cope with the volume of work required. Over time, the culture of compliance suffers, even among those companies that should be expected to have the resources to comply. Success is greater when the application of IAS/IFRS is confined to public interest entities only, and when limited resources are focused on ensuring compliance by these entities.

16. The situation with respect to auditing standards is more straightforward, given the international consensus that International Standards on Auditing are suitable for the conduct of all financial statement audits, subject to the need to improve ISA on particular issues as discussed above. Instead, the difficulty arises in the determination of the scope of legal requirements for audit. There are inherent limitations on the ability to perform a proper audit of many smaller entities because of the ability of owner/managers to override controls, and many countries have only limited audit capacity. As with IAS/IFRS, the application of ISA to excessive numbers and/or inappropriate types of entities almost always leads to problems of general compliance, even on those engagements where compliance should be possible.

Illustrations

Accounting Standards:

In country ABC, the accountancy law requires that all private sector enterprises present IAS/IFRS-based financial statements. This requirement significantly increased the accounting-related expenses with little benefit, generated a significant issue in terms of corporate income tax assessment and collection, and eventually resulted in pervasive noncompliance with financial reporting requirements.

Auditing Standards:

In country ABC with a population of approximately 10 million, over 15,000 companies are subject to annual statutory audit requirements. A significant number of them are family-owned small- and medium-sized enterprises in which there is little public interest in such a requirement

[8] The IASB is currently developing a set of standards applicable to small- and medium-sized enterprises.

to be audited. Also, although International Auditing Practice Statement (IAPS) 1005, “The Special Considerations in the Audit of Small Entities” provides guidance on auditing small entities, the quality of small entity ISA audits was determined to be low, and significant compliance gaps with ISA were found.

Non-observability of compliance

17. Third-party users are usually unable to directly determine if a preparer or auditor has complied with the appropriate standards.[9] Instead, users must rely on a range of intermediary governance, regulatory and reputational agency bodies (e.g., auditors, underwriters, analysts), which may not function at the necessary level of quality in some countries. In such countries, it is effectively impossible for a third party that does not have special negotiating leverage (e.g., a major lender to the company) to gain any insight into actual levels of compliance and/or to exercise pressure for improvement, thereby reducing the incentives for preparers and auditors to comply. Particular problems of non-observability arise when audited financial statements are not easily available to stakeholders. In many countries, disclosure mechanisms foreseen in the law (e.g., company registries) do not function as desired. In others, disclosure by means of publication in official gazettes or newspapers is not effective, when disclosure is limited to the primary financial statements and does not include the notes to the financial statements.

Illustrations

Accounting Standards:

In country ABC, the ROSC assessment noted discrepancies between actual accounting policies followed by financial institutions and the “boilerplate” disclosures in their IFRS financial statements. A number of interviewed banks indicated that they calculate impairment in the unsecured portion of loans and receivables on the basis of a provisioning matrix that specifies a range of fixed provisioning rates for the number of days a loan has been classified as nonperforming (for example, 0 percent if less than 30 days, 1 percent if 30-90 days, etc.). However, the loan measurement accounting policy in their IFRS financial statements was word-for-word compliant with IAS 39, which requires impairment or loan losses to be calculated as the difference between the asset’s carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset’s original effective interest rate. Auditors and financial statement preparers often commented that disclosed accounting policies—reflecting comments from senior audit partners at IFRS desks abroad—differ from actual accounting practices within the audited company. The concern is that IFRS-based financial statements may be complying in form but not in substance.

Auditing Standards:

[9] This particularly holds true regarding auditing standards. When a reader receives a set of financial statements with an unqualified audit report, the reader is rarely in a position to assess whether it is the result of a perfect audit or of an inadequate or acquiescent audit.

IFRS/IAS do not allow the carrying of assets at more than their recoverable amount. In country ABC, the resulting impairment charge is tax deductible. The ROSC results showed that impairment charges were mainly recorded by profit-making companies in an effort to reduce their taxable income, whereas loss-making companies generally refused to record impairment charges. Auditors have generally expressed an emphasis of matter audit opinion rather than a qualified audit opinion when they noted such instances of noncompliance. This is a lenient and, most would argue, incorrect audit opinion under ISA. Such an audit opinion does not adequately protect the public. These overvalued assets present a rosier picture of the company's financial position than actually exists.

18. At this juncture, it is appropriate to highlight that the ROSC methodology is essentially a top-down approach and should not be considered as a substitute for a future ideal compliance model involving a bottom-up assurance approach. The ROSC methodology uses stratified random sampling to select audited financial statements and it cannot be considered to be representative of all companies and auditors. Hence, the ROSC findings, although useful for illustrating potential problems in financial reporting, pertain to shortcomings found in the audited financial statements of specific companies.

Areas for improvement in the standards themselves

19. International standards are not always geared to protecting the public interest. While the governance of accounting and auditing standard-setting arrangements has been significantly improved in recent years and is still being improved, some standards – particularly auditing standards – remain to be revised. The ROSC reports support the adoption of IFRS/IAS for public interest entities and the adoption of ISA to avoid inefficient use of resources on standard-setting at national level around the world, as well as the subsequent inefficiencies caused by audit firms and their clients having to adhere to several sets of standards. At the same time, however, the ROSC results point to weaknesses in the standards, which adversely impact their implementation. Such weaknesses may result from efforts to compromise when setting the standards, undue political or lobbying influence in standard-setting activities, lack of detailed rules, and areas that are not yet covered by international standards.

20. For example, many stakeholders believe that fraud detection should be recognized as a responsibility of statutory auditors. They contend that the scope of audits must be expanded beyond the current requirements of International Standards on Auditing, and looking for fraud must be made an affirmative audit obligation. With respect to group audits, the International Standard on Auditing regarding the use of the work of another auditor permits - when the local regulations of a country also allow for this - that a principal auditor base his or her audit opinion on the financial statements taken as a whole *solely upon* the report of another auditor regarding the audit of one or more components. These weaknesses attest to the lack of adequate public oversight of the standard-setting process. Therefore, some countries that adopted ISA supplemented ISA

with additional requirements (e.g., that the group auditor bear full responsibility for the audit report on the consolidated financial statements).

Mismatch between accounting and auditing requirements and market demands

21. International accounting and auditing requirements do not exist in a vacuum; they are designed to fit the needs of disclosure-based governance and regulatory regimes, where high-quality audited financial statements provide information that can be relied upon by a range of users external to the reporting entity for significant decision-making purposes. Where such disclosure-based environments exist, or are being put in place, the conditions for successful implementation of international standards are more favorable than in the absence of such environments, given the differences in incentives for concerned policymakers and stakeholders. Thus the relative importance of foreign direct investment flows, as compared with foreign portfolio investment flows, has an influence on shaping the conditions for implementation, as do patterns of share ownership. Where relatively concentrated blocks of equity ownership are in the hands of controlling shareholders (often the State, founding families, managers who have gained control of enterprises during privatization, or foreign "strategic" shareholders), the mechanisms of corporate governance are less reliant on external disclosure, since the controlling shareholders have alternative access to internal, non-disclosed information. The same can hold for providers of finance, who may place greater reliance on the value of collateral or add specific financial reporting requirements in loan covenants. Similarly, when regulators and other authorities have the power to impose their own reporting requirements (e.g. for tax or prudential reporting), they may not see the need to invest in improving the regime for general purpose financial reporting and auditing. The enhanced transparency that flows from the robust application of international standards may not be perceived by certain influential stakeholders as being in their interests, and public policy decisions may be skewed in a manner which is not welfare-maximizing for the economy as a whole. Formal requirements for the application of international standards may be introduced, perhaps in response to external pressure, but the likelihood of successful implementation must always be assessed against the backdrop of political economy realities.

Mismatch between accounting and auditing requirements and the capacity to comply

22. The application of international standards requires certain minimum levels of capacity (i.e., appropriately qualified individuals), which depends on the availability of opportunities for relevant and adequate education, training and experience. The greater the gap between existing national and international standards, and the shorter the period to complete the transition, the greater the capacity building challenge to overcome. The development and enhancement of capacity applies to educators, regulators and users as much as to preparers and auditors, and places demands on both institutions and individuals. Systems, methodologies, application guidance, curricula, teaching and training materials, examination and certification procedures, and much else must be adapted to support the new obligations. Differences in language can limit the application of resources developed elsewhere, as well as the transfer of knowledge and experience

from one country to another. Where the number of entities subject to international standards is modest because of local specificities (e.g. few public interest entities), cost-benefit considerations may constrain investments to support the implementation of international standards, at least in the short- to medium-term. Mechanisms to apportion the costs of implementation to those stakeholders who will benefit may not function adequately due to free-rider problems often associated with the financing of public goods, and public financing may not be a viable alternative because of conflicting demands on scarce resources. Even where resources can be mobilized to launch the process of capacity development and enhancement (such as through development assistance), putting in place financing mechanisms that are sustainable in the longer term is more of a challenge. Unfortunately, there are many examples of reform initiatives that began well but collapsed when the initial pump-priming funding ran out.

Mismatch between accounting and auditing requirements and domestic enforcement capacity

23. The effectiveness of regulatory bodies in the monitoring and enforcement of accounting and auditing standards is a strong determinant of the quality of application such standards. This is true for a variety of reasons, among them: the inability of third party users to assess compliance with standards, agency theory problems that can lead to imperfect alignment of the interests of various stakeholders concerned with the quality of a company's financial reporting, and the public goods and coordination issues associated with the application of accounting and auditing standards. Recent scandals have drawn attention to weaknesses in previous approaches to monitoring and enforcement, as well as to the limitations of systems that place significant reliance of self-regulation. The risks of conflicts of interest now receive greater attention; steps have been taken to ensure greater segregation of functions between those involved in the financial reporting process. Significant efforts have also been made to enhance the capacity and powers of various regulatory bodies. The need for public interest oversight of the audit profession, setting of auditing and ethical standards, and audit quality assurance programs is acknowledged, as is the need for the various regulatory bodies concerned with different aspects of financial reporting to improve the coordination of their activities, all within a coherent and consistent legislative framework.

24. There is a progressive move away from complete self-regulation of auditing by the accountancy profession towards independent regulation within a statutory framework. Unfortunately, most of these reforms are taking place in relatively developed jurisdictions, while most countries that have been subject to ROSC accounting and auditing assessments are still struggling to put in place the basics of effective regulation. Existing regulatory institutions, including banking and securities regulators, frequently lack the mandate, resources and methodologies required to monitor and enforce accounting and auditing requirements. As a rule, though, given the greater role of the banking sector in financial intermediation in these countries, the performance of banking supervisors is better. However, where such regulators are concerned primarily with the respect of their own special-purpose requirements, the contribution of their activities to the quality of the general purpose financial statements made publicly available is

constrained. Mechanisms for public oversight of the audit function are rare, and valid questions are raised about the applicability of models introduced recently in more developed jurisdictions, given the different relative roles of the various stakeholders. The robustness of self-regulatory bodies is questionable, especially in those jurisdictions where the record of dealing with conflicts of interest is not encouraging. Even where formally independent regulatory bodies do exist, regulatory capture is frequent, and the judicial system is not considered an effective mechanism for seeking redress in matters relating to accounting and auditing. The same applies to the enforcement of corporate governance measures, which can contribute to improvements in accounting and auditing. Additional problems arise in the case of public interest entities that do not operate in regulated sectors.

The special role of the international audit firm networks

25. As previous sections have demonstrated, the successful implementation of international accounting and auditing standards is very dependent on local conditions. At the same time, various stakeholders—e.g., users of financial statements prepared by companies seeking access to third-country financial and capital markets, investors wishing to diversify their portfolios internationally, and parent companies requiring assurance on the financial statements prepared by foreign subsidiaries—may wish to compensate for national weaknesses, in order to be able to rely on financial information for decision-making purposes. Purely domestic stakeholders may also hope to "import" assurance by turning to auditors which they consider to offer a degree of audit quality that goes beyond that which one could expect from the operation of local regulatory and enforcement mechanisms This explains the emergence of international audit firm networks, which operate using a common brand name globally. Since, as noted earlier, a third party user is usually unable directly to determine whether international standards have been complied with by an auditor, users place reputational reliance on these network brand names, even though the constituent member firms of these networks are typically owned, managed, controlled and regulated at national level, and the networks themselves are not subject to any regulatory oversight or supervision.

26. Despite the expectations that flow from the use of their global brands, the ROSC results and audit failures over recent years in several jurisdictions would suggest that international audit firm networks do not deliver consistent, high-quality audit services across the globe. International audit networks have not made explicit the service delivery assertion which underlies the use of a common network/firm name by different practices in different jurisdictions around the world, nor have they made clear how users of audit reports produced by these different practices are supposed to obtain assurance that this assertion is being delivered upon. In the aftermath of recent audit failures, the networks have undertaken a number of initiatives to respond to the criticisms that ensued. Among these was the creation of the Forum of Firms (FoF), in January 2001. The FoF is an organization of international firms that perform audits of financial statements that are or may be used across national borders ("transnational audits"). Members of the Forum voluntarily agree to meet certain requirements as detailed in the FoF Constitution. These include a commitment to the FoF "Quality Standard", which requires Member Firms to:

- have policies and methodologies used for conducting transnational audits (but not other audits which are nonetheless “branded” with the same network name) which as a minimum require compliance with International Standards on Auditing in addition to relevant national standards on auditing;
- comply as a minimum with the applicable sections of the IFAC Code of Ethics as determined by the Transnational Auditors Committee (TAC) of IFAC for inclusion in the Quality Standard, in addition to relevant national codes of ethics;
- maintain training programs, as appropriate, to keep partners and staff who perform transnational audits aware of international developments relevant to financial reporting including auditing and ethics; and
- maintain appropriate quality control standards in accordance with International Standards on Auditing and International Standards on Quality Control, as issued by the IAASB, in addition to relevant national quality control standards. In addition, conduct regular globally-directed internal quality assurance reviews to monitor compliance with the Member Firm's policies and methodologies for conducting transnational audits.

27. An International Quality Assurance Review (IQAR) process had originally been envisioned by the FoF to review Member Firms’ policies, methodologies and work undertaken in relation to transnational audits to assess whether they are in compliance with the Quality Standard, but this has now been deferred, given the major strengthening of national audit regulatory regimes in several major jurisdictions. However, the FoF has no mechanism for monitoring its members’ compliance with the Quality Standard.

28. The findings of the Accounting and Auditing ROSC assessments suggest that many member firms of networks, which are also FoF members, do not comply with the Quality Standard for transnational audits. These member firms may be unaware that their international network has made such a commitment and/or they may not consider themselves bound by it, since they are independently owned, managed and controlled. It is therefore unclear how audit report users are supposed to obtain reasonable assurance that the commitment to the FoF Quality Standard is actually delivered upon, at the level of individual network member firms and transnational audit engagements. Because of legal liability concerns, the international networks do not wish to exercise control, and/or to be seen to be exercising control, over their individual member firms. There are also doubts as to whether such control is even possible, given the network governance and management arrangements currently in place. Neither the networks nor their member firms make public the results of their internal quality assurance reviews to monitor compliance with network policies and methodologies for conducting transnational audits. This means that users cannot rely on the FoF, the networks, or individual member firms to provide any verifiable assurance, either *ex ante* or *ex post,* that the Quality Standard is delivered upon. Instead, users can only fall back on the quality of the local regime for the regulation of audit. It remains to be seen how sustainable this situation will be, in terms of managing the networks’ global brands.

III. THE NEED FOR INTERNATIONAL CONSENSUS ON A COMPREHENSIVE FRAMEWORK OF PRINCIPLES FOR THE REGULATION OF ACCOUNTING AND AUDITING

29. As evident from the earlier sections, effective regulation is the key to successful implementation of international standards, but international accounting and auditing standards themselves do not set out requirements as to how such effective regulation should be exercised. Guidance is not provided on how to "import" international standards into national legislative and regulatory systems, on the design and operation of appropriate regulatory frameworks, or on the interfaces with other regulatory instruments and institutions (such as those for banking and securities regulation) which could contribute to the monitoring and enforcement of international standards. As currently drafted, international accounting and auditing standards implicitly assume the existence of legal, institutional and policy conditions ("preconditions") that are often undeveloped or absent in many countries. The structure of national economies, and the role played by high quality external financial reporting, shape the extent to which these "preconditions" present themselves, and efforts to promote the implementation of international standards need to have regard to these specificities.

30. To strengthen the regulatory arrangements essential for the successful implementation of international standards, countries should give greater attention to regulatory preconditions. To do this, however, they need help in understanding what needs to be done to frame the appropriate legal and institutional requirements within a policy framework that ensures consistency with other related areas of regulation, including company law. For countries that have recently joined the EU, plan to do so, or otherwise have made a conscious decision to align themselves with the requirements of the *acquis communautaire*, reliance can be placed on the rapidly evolving approaches within the Union, which have the added benefit of being drafted to meet the needs of an integrated market comprising several countries. However, it is not evident that the *acquis* is appropriate to other countries. The relevant international organizations should work together to develop a consensus on a comprehensive framework of principles for the regulation of accounting and auditing and to support its adoption by the competent national authorities. Special efforts should be made to strengthen and leverage the linkages between the various standards and codes that affect the implementation of international accounting and auditing standards (e.g., banking supervision, securities markets, insurance, and corporate governance) and to fill any gaps which remain. Such principles should explicitly consider the regulatory implications of the diversity of financial systems and market structures across countries. A useful starting point would be the results of the International Organization of Securities Commissions (IOSCO)/Basel Committee/International Association of Insurance Supervisors (IAIS) Joint Forum Core Principles Cross-Sectoral Comparison.

APPENDIX

OVERVIEW OF THE ACCOUNTING AND AUDITING ROSC PROGRAM

Introduction

In the wake of the international financial crisis of the 1990s, the international community embarked on a range of initiatives to strengthen the international financial architecture. The objectives of these initiatives were crisis prevention, mitigation, and resolution. The agenda focused on weaknesses in the international financial system that could potentially contribute to the propensity for and magnitude of global financial instability, hence requiring collective action at the international level.

There is widespread recognition that global financial stability rests on robust national systems. In a world of integrated capital markets, financial crises in individual countries can imperil global financial stability. This provides a basic "public goods" rationale for enhanced measures at the country level that ultimately benefit international and national systems.

Role of the ROSC in the International Financial Architecture

At the international level, standards enhance transparency. They identify weaknesses that may contribute to economic and financial vulnerability. They foster market efficiency and discipline. At the national level, standards provide a benchmark to identify vulnerabilities and guide policy reform. To best serve both international and national objectives, the scope and application of such standards need to be assessed in the context of a country's overall development strategy and tailored to individual country circumstances. The Financial Stability Forum and others have emphasized, in particular, the role of best practice standards and codes in strengthening the international financial architecture.

In this context, the World Bank and the International Monetary Fund (IMF) initiated the joint ROSC initiative, which covers twelve sets of internationally recognized core standards and codes relevant to economic stability and private and financial sector development.[10] Each core standard is assessed and reported on in an individual module. Under this modular approach, the IMF takes the lead in preparing assessments in the areas of data dissemination and fiscal transparency. Modules for the financial sector (transparency in monetary and financial policies, banking supervision, securities market regulation, insurance supervision, payments and settlements, anti-money laundering and the combating of financing of terrorism (AML/CFT),) are mostly derived from the Financial Sector Assessment Program

[10] The twelve sets of standards cover data dissemination, fiscal transparency, transparency in monetary and financial policies, banking supervision, securities market regulation, insurance supervision, payments and settlements, anti-money laundering and the combating of financing of terrorism (AML/CFT), corporate governance, accounting and auditing, and insolvency and creditor rights.

(FSAP).[11] The World Bank takes the lead in corporate governance, accounting and auditing, and insolvency regimes and creditor rights.

The ROSC and the FSAP programs are tools to assess financial sector vulnerability and development needs. They provide input to the IMF for its surveillance activities and are useful instruments to support the policy dialogue of international financial institutions, policymakers, and the private sector. They can contribute to the design of development lending operations, assist in the preparation of key policy documents, and provide benchmarks for the design and monitoring of technical assistance and capacity-building programs. To remain useful, assessments of progress in the implementation of standards are updated periodically.

The IMF and the World Bank have set up websites to disseminate the final ROSC assessments to the public.[12]

Objectives of the ROSC–A&A Module

The World Bank is responsible for assessing the accounting and auditing module of the ROSC, known as the Review of Accounting and Auditing Standards and Practices. The Review's objectives are to:

Assess the ***comparability*** of national accounting and auditing standards with International Financial Reporting Standards (IFRS)[13] and International Standards on Auditing (ISA)[14], respectively, and the degree to which corporate entities ***comply with*** established accounting and auditing standards in the country; [15] and

Assist the country in ***bridging the identified gaps*** between its current standards and practices, and internationally recognized accounting and auditing standards.

The ROSC-A&A module focuses primarily on financial reporting by *public interest entities*. "Public interest entities" are defined as entities of significant public interest because their business, their size, their number of employees, and/or their corporate status are such that they have a wide range of stakeholders. Examples of such entities include credit institutions, insurance companies, investment firms, pension firms and

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11 The FSAP, a joint IMF and World Bank effort introduced in May 1999, aims to increase the effectiveness of efforts to promote the soundness of financial systems in member countries. See http://www1.worldbank.org/finance/html/fsap.html.

12 The ROSC website, including details of the twelve core standards and country modules, is available at http://www.worldbank.org/ifa/rosc.html.

13 Within this document, IFRS refer to both International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board and the Standards issued by the Board of the International Accounting Standards Committee, and each applicable Interpretation of the International Financial Reporting Interpretations Committee.

14 International Standards on Auditing (ISA) are promulgated by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC).

15 Within this document, the term "accounting" refers both to accounting and reporting.

listed companies. However, the ROSC-A&A does also consider issues related to financial reporting by small and medium-sized entities (SMEs).

Comparability of National and International Standards and Compliance

The ROSC-A&A review entails an evaluation exercise that (a) assesses the strengths and weaknesses of existing *institutional frameworks* that underpin financial accounting and auditing practices; (b) determines the *comparability* of national accounting and auditing standards with internationally recognized standards (IAS/IFRS and ISA); and (c) examines the degree of *compliance* with national accounting and auditing standards, and evaluates the effectiveness of monitoring and enforcement mechanisms for ensuring compliance with existing national standards, rules, and regulations.

Institutional Framework

The institutional framework should promote high-quality accounting and auditing practices. The institutional framework, as examined by the ROSC-A&A in each country, includes (a) laws and regulations, (b) the history and current state of the accounting and auditing profession, (c) the strengths and weaknesses of accounting academic and professional education, (d) the accounting and auditing standard-setting process, and (e) arrangements for ensuring compliance with accounting and auditing requirements. The ROSC-A&A module focuses on the current state of the institutional framework and provides policy recommendations for strengthening the framework, in order to foster high-quality accounting and auditing practices.

While IAS/IFRS and ISA are the two benchmarks that the ROSC-A&A review uses to assess accounting and auditing standards and practices in any given country, there are no international regulatory standards for accounting and auditing. Efforts to address current gaps that have come to the fore in light of recent corporate governance and accounting scandals are still underway. In the absence of standards, World Bank staff draw on their own experience in assessing the institutional frameworks referred to above.

Comparability of National and International Standards

The benchmarks used in developing the methodology for this assessment are IAS/IFRS and ISA. Achieving conformity of national accounting and auditing standards with IAS/IFRS and ISA promotes sound financial reporting in an economy. For various reasons, the standards and regulations of different countries have reached various levels of conformity with comparable international standards. The ROSC-A&A module helps identify these gaps.

Compliance with National Standards

Corporate stakeholders depend on access to high-quality financial information. While setting accounting and auditing standards is an important step in developing a sound financial reporting environment, enforcement of these standards is even more important. The lack of an effective and efficient mechanism to ensure compliance with established accounting and auditing standards contributes to the weakness of a financial reporting environment.

Bridging the Gaps

With regard to the second objective of bridging identified gaps, the ROSC–A&A module also identifies areas for improvement that help policymakers and other country stakeholders to develop a strategy and an action plan for enhancing accounting and auditing standards and practices in a country.

ROSC–A&A Methodology

The ROSC-A&A module evolves from a participative approach with the strong involvement of policymakers and other country stakeholders. The World Bank has developed a diagnostic tool that captures a comprehensive review of accounting and auditing standards and practices in a country.[16] The World Bank also supplements the information from the diagnostic tool with a due diligence exercise in capturing primary experiences of practitioners and other facts on professional accounting and auditing practices in a country. Upon completion of the due diligence, World Bank staff prepare a report presenting the factual findings arising from the review and make policy recommendations to help the country enhance its accounting and auditing standards and practices. Country stakeholders review the draft report. World Bank staff then prepare a final report taking into account comments received from the stakeholders and submit it to the country authorities for approval and permission to publish. Once agreed, these reports are published on the World Bank's website.[17]

Country stakeholders and World Bank staff co-develop a country strategy and action plan based on the recommendations of the ROSC report, and ultimately, the country strategy and action plan are implemented.

Involvement of Policymakers and Country Stakeholders

At the inception of a ROSC-A&A review in a given country, the country authorities (policymakers) identify the country stakeholders who have an interest in accounting and auditing matters. These stakeholders may include representatives from the Ministry of Finance, Ministry of Justice, securities market regulator, banking regulator, insurance companies and other non-banking financial institutions regulator, higher accounting educational institutions, professional accounting and auditing bodies, auditing firms, and institutional investors.

[16] The diagnostic tool is available at www.worldbank.org/ifa/rosc_aa.html.

[17] See http://www.worldbank.org/ifa/rosc_aa.html .

The in-country stakeholders participate in assessing key factors during the ROSC-A&A process, including the strengths and weaknesses of the existing institutional framework that underpin accounting and auditing practices; the extent of compliance with national accounting and auditing standards in practice; and the effectiveness of enforcement mechanisms. They also assist in identifying areas for improvements in accounting and auditing standards and practices. They act as a counterpart to the World Bank in the preparation of the ROSC-A&A report and country action plan.

Progress in Assessments

As of end-June 2004, 38 A&A ROSC modules have been completed, of which 20 have been published. Regionally, Europe and Central Asia has completed the greatest number of assessments, with 17 completed; followed by Latin America and the Caribbean, and the Middle East and North Africa—both with seven completed assessments; the Africa region has completed five; and East Asia and Pacific, and South Asia have completed two each. So far, the majority of A&A assessments have been conducted in middle-income countries, 27 in all, compared to only seven in low-income countries and two in high-income countries. However, as growing numbers of low-income countries have accepted the importance of private sector-led economic development, the need for strengthening corporate accounting and auditing practices has been increasing in these countries.