

## IV. Selected Accounting and Auditing Issues

### 1. Introduction

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

### 2. International Guidelines and Surveillance

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

Table 2: Selected International Guidelines, Standards and Codes

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

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

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

### **3. International Accounting Standards (IAS)**

#### **Introduction**

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

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

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

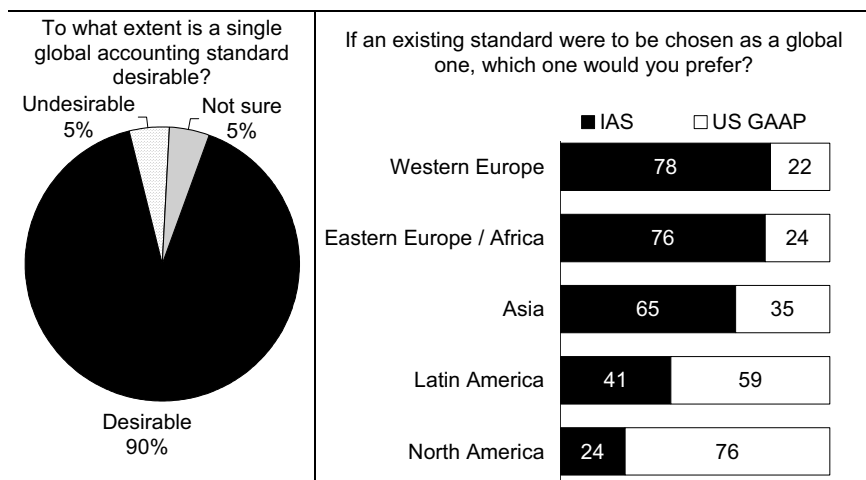
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<sup>30</sup> IMF, September 2000. *Experimental Reports on Observance of Standards and Codes (ROSCs)*. [www.imf.org/external/np/rosoc](http://www.imf.org/external/np/rosoc)

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

<sup>32</sup> While IASB now expects its standards to be called IFRSs, this report uses the term IAS, for continuity.

Figure 4: McKinsey Institutional Investor Survey



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

### Box 1: Will US GAAP Converge with IAS?

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

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

### Benefits of Direct IAS Adoption

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

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

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

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

## General Criticisms of IAS

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

### Box 2: Detailed Standards<sup>36</sup>

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

<sup>34</sup> See [www.iasplus.com](http://www.iasplus.com)

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

<sup>36</sup> Epstein, Barry J. and Abbas Ali Mirza. 2001. *IAS 2001: Interpretation and Application*. New York: John Wiley & Sons.

## Challenges of Direct IAS Adoption

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

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

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

## IAS Copyright and Pricing

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

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

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

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

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

**Table 3: Prices for IAS Materials**<sup>40</sup>

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

#### 4. Financial Reporting for Smaller Enterprises (SMEs)

##### Introduction

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

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

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

<sup>39</sup> [www.ifac.org](http://www.ifac.org)

<sup>40</sup> Source: [www.iasc.co.uk](http://www.iasc.co.uk) (accessed on 28 July 2002).

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

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

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

### UNCTAD ISAR Framework for SME Accounting and Reporting

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

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

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

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

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

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

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

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

## IASB Initiatives on SME Accounting and Reporting

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

## 5. Auditing Standards and Practices

### Introduction

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

Recent US corporate accounting scandals have forced auditing standards and practices into the international limelight. The US has taken

decisive action to improve financial reporting arrangements (see Box 3). Other countries have also reviewed their arrangements.<sup>43</sup>

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

### Box 3: Stricter Rules for US Capital Markets

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

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

<sup>43</sup> See, for example:

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

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

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

## Auditor Appointment and Termination

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

### Box 4: Sacking of Auditors in China a Worrying Trend<sup>46</sup>

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

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

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

Table 4: Auditor Appointment and Dismissal

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

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

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

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

### Auditor Independence

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

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

<sup>47</sup> IFAC. 1996. *Code of Ethics for Professional Accountants*. New York: IFAC.

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

**Table 5: Auditor Independence and Incompatible Activities**

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

### Audit Reporting Requirements

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

Table 6: Audit Reporting

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

## Auditor Liability

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

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

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

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

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

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

**Table 7: Auditor Liability**

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

## 6. The Accountancy Profession

### Introduction

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

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

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

### Factors Affecting Development of the Accountancy Profession

Some economies have a better professional infrastructure than others because of their legal traditions. Former British colonies (e.g., Canada and Malaysia) use common law systems and rely on independent judges and juries and legal principles supplemented by precedent-setting case law to respond to evolving circumstances. Civil law countries (e.g., Indonesia and the Republic of Korea) rely on legal codes that contain very specific rules and are less adept at responding to changing environmental needs. Indeed,

legal traditions affect the development of professions to a remarkable degree—researchers have found a robust negative correlation between the civil law tradition and lack of professions, on the one hand, and a supporting and beneficial impact of professions on the rule of law, on the other.<sup>51</sup>

## Relevant Professional Standards and Guidance

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

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

## IFAC Education Standards and Guidelines

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

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

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

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

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

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

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

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

## UNCTAD Initiatives

A 1999 UNCTAD report considered accountancy education and qualifications.<sup>56</sup> It provides a useful set of benchmarks, in particular:

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

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

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

## 7. Public Sector Reporting

### Introduction

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

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

<sup>56</sup> UNCTAD. 1999. *International Accounting and Reporting Issues: 1999 Review*. New York: United Nations.

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

**Box 5: Accrual Accounting in the United Kingdom**

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

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

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

**IFAC Public Sector Committee (PSC)**

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

**Table 8: Eleven Selected ADB DMCs: Accounting Status**

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

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

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

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

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

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

### Box 6: PSC Study No. 14: Transition to the Accrual Basis of Accounting: Guidance for Governments and Government Entities<sup>57</sup>

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

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

## SNA and GFS and IPSAS

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

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

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

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

<sup>58</sup> IMF. 2001. *Government Finance Statistics Manual 2001*. Washington DC: IMF. URL: [www.imf.org](http://www.imf.org)

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

## **8. Conclusion**

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