

REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC) Pakistan

ACCOUNTING AND AUDITING

March 31, 2005

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EXECUTIVE SUMMARY

Pakistan has made progress in closing the gap between local requirements for corporate financial reporting and international standards by adopting International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA). Over the past few years, this has contributed to significant improvements in corporate financial reporting. Despite such achievements, there are still varying compliance gaps in both accounting and auditing practices. These gaps are likely to stem from inadequate technical capacities of the regulators, absence of implementation guidance, lack of independent oversight of the auditing profession, and shortcomings in professional education and training.

This report provides an assessment of accounting and auditing practices in Pakistan with reference to the requirements of the IFRS, issued by the International Accounting Standards Board (IASB), and ISA, issued by the International Federation of Accountants (IFAC). This assessment is positioned within the broader context of the country's institutional framework and capacity needed to ensure the quality of corporate financial reporting. Building on the past achievements, greater efforts are necessary for strengthening the capacity of the regulators and ensuring compliance with applicable standards and codes.

The principle-based policy recommendations outlined in this report are aimed for the consideration of appropriate authorities in Pakistan. These recommendations will be used as inputs in developing a Country Action Plan, geared toward strengthening the corporate financial reporting regime in Pakistan. The objectives of these recommendations are to consolidate the prior achievements, improve knowledge base among auditors and the preparers of financial statements, and strengthen the monitoring and enforcement mechanisms for ensuring compliance with applicable standards and codes. The recommendations include improving the capacity of regulators and professional bodies, upgrading accountancy education and training with focus on practical application of IFRS and ISA, issuing and disseminating implementation guidance on applicable standards, instituting a system for independent oversight of auditing profession, developing simplified SME reporting requirements, upgrading the licensing procedure of professional accountants and auditors, and enhancing the delivery of continuing professional education. These recommendations are expected to pave the way in achieving further improvements in the country's corporate financial reporting practices. This will also create a more successful working environment for professional accountants and auditors in Pakistan, many of who are capable of rendering world-class services.

PREFACE

There is a broad agreement among members of the international financial community that the observance of international standards and codes are pivotal in strengthening national and international financial architecture. In a world of integrated capital markets, financial crises in individual countries can imperil international financial stability. This provides a basic public goods rationale for minimum international standards which would benefit both international and individual national systems. At the international level, international standards enhance transparency as well as multilateral surveillance. They help to better identify weaknesses that may contribute to economic and financial vulnerability, foster market efficiency and discipline, and ultimately contribute to a global economy that is more robust and less prone to crisis. At the national level, international standards provide a benchmark that can help identify vulnerabilities as well as guide policy reform. To best serve these objectives, however, the scope and application of such standards needs to be assessed in the context of a country's overall development strategy and tailored to individual country circumstances.

Following the Asian financial crisis in 1997, the international community recognized the real need to assess the degree to which a country observes the internationally recognized standards and codes. The World Bank and the International Monetary Fund (IMF) instituted *Reports on the Observance of Standards and Codes (ROSC)* that assesses key areas in a country's economic well-being: accounting and auditing, anti-money laundering and combating the financing of terrorism, banking supervision, corporate governance, data dissemination, fiscal transparency, insolvency and creditor rights, insurance supervision, monetary and fiscal policy transparency, payments system, and securities regulation.

The ROSC Accounting & Auditing (A&A) review focuses on the institutional framework regulating the accounting and auditing practices, comparability of national accounting and auditing practices with international standards and best practices using International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA) as benchmarks, and evaluating the effectiveness of enforcement mechanisms for ensuring compliance with applicable standards and codes. The final draft report is submitted to the country authorities for comment, approval, and permission to publish. Once agreed, the report is published on the World Bank's website. An overview of the ROSC A&A Program and a detailed presentation of the methodology are available at http://www.worldbank.org/ifa/rosc_aa.html

The ROSC A&A review exercise was carried out in Pakistan during the period from October to December 2004 through a participatory process involving various stakeholders. The stakeholders include the Securities and Exchange Commission of Pakistan, State Bank of Pakistan, Institute of Chartered Accountants of Pakistan, Institute of Cost and Management Accountants of Pakistan, banks, leasing companies, insurance companies, state-owned enterprises, audit firms, stock exchanges, finance companies, corporate accountants, and academics. Relevant stakeholders provided detailed comments on the draft report, delivered to the authorities on March 31, 2005. The report was updated on the basis of comments from relevant in-country stakeholders and feedback from participants in a dissemination workshop held in Islamabad on November 17, 2005.

The Pakistan ROSC A&A was prepared by a World Bank team comprising Ismaila B.Ceesay – Senior Financial Management Specialist and Task Leader (SARFM); M. Zubaidur Rahman – Program Manager and Study Advisor (OPCFM); Humayun Murshed (international consultant); and Furqan Saleem (national consultant).

I. INTRODUCTION AND BACKGROUND

1. This report is based on an assessment of accounting and auditing practices in the Islamic Republic of Pakistan. It forms part of a joint initiative between the World Bank and the International Monetary Fund (IMF) on Reports on the Observance of Standards and Codes (ROSC). The assessment focuses on the strengths and weaknesses of corporate accounting and auditing practices in Pakistan and involves a review of both mandatory requirements and actual practice. It uses International Financial Reporting Standards (IFRS)¹ and International Standards on Auditing (ISA) as benchmarks and draws on recent global experiences and best practices in the field of corporate financial reporting and audit regulation. The assessment used a diagnostic template developed by the World Bank to facilitate collection of information, which was complemented by the findings of a due diligence exercise, based on a series of meetings with key stakeholders conducted by World Bank staff. The intended audience of this report includes national and international market participants who have an interest in the corporate financial reporting regime of Pakistan.

2. With a population of about 159 million, Pakistan has a per capita gross national income (GNI) of US\$520, and poverty still remains a serious concern.² However, the country has made strides in improving a deteriorating macroeconomic situation. In 2004 gross domestic product (GDP) grew by an estimated 6.4 percent. The financial sector grew during fiscal year (FY) 2002-03 adding assets of about US\$9.1 billion, accounting for almost 85 percent of GDP.³ The private sector dominates the financial sector, representing an asset share of 52 percent. There are 40 banks and 54 insurance companies operating in Pakistan. As of September 2003, commercial banking assets amounted to 54 percent of GDP.⁴ The asset structure in the insurance sector is heavily skewed toward state-owned insurance companies in both life and general insurance;⁵ the total assets in this sector have grown by about 15 percent during FY2002-03.

3. The Government of Pakistan has undertaken a broad agenda of stabilization and structural reform to privatize public sector enterprises, strengthen public and corporate governance, and reform the banking sector. Foreign exchange reserves continue to grow, supported by export growth and steady remittances by Pakistanis working overseas. The improvements in governance of public entities, relatively stable foreign exchange rate, fall in the interest rates, and the expectation of the continuation of improvement in the business climate has begun to show up in increased foreign investment, particularly in the textile and oil and gas sectors.⁶

¹ IFRS refers to all standards and related interpretations issued by the International Accounting Standards Board (IASB) and its predecessor the International Accounting Standards Committee (IASC), which issued International Accounting Standards (IAS). In this report, IFRS also refers to IAS.

² *The World Bank in Pakistan, Country Brief*, September 2004.

³ *Financial Sector Assessment Report 2003*, State Bank of Pakistan.

⁴ *Pakistan: Financial System Stability Assessment*, including ROSC reports on monetary and financial policy transparency, banking supervision, and securities regulation; International Monetary Fund, 2004.

⁵ The share of one of the state-owned insurance companies, State Life Insurance Corporation, was 70.5 percent of the total assets of the entire industry during FY2002-03.

⁶ Pakistan Country Update, www.worldbank.org.pk.

4. There are 663 companies listed in the country's premier securities market, Karachi Stock Exchange,⁷ with a market capitalization of US\$25 billion.⁸ Trading in Pakistan's stock markets is highly concentrated. Although the stock market is relatively small in size, its role can be of paramount importance for the consolidation of the private sector, which in turn can help support the country's economic growth. High-quality corporate financial reporting practices are crucial for enhancing investors' confidence and orderly operation of the securities market.

5. Foreign direct investments in Pakistan exceeded US\$800 million during FY2002-03.⁹ International investors call for comparable financial information from countries competing for foreign investments. This requires that the corporate sector in Pakistan comply with internationally acceptable standards and codes. Pakistan has created a statutory framework to regulate business activities, including establishment of regulatory institutions for enforcing accounting and auditing standards and codes. In order to ensure high-quality corporate financial reporting, appropriate enforcement mechanisms need to be in place.

II. INSTITUTIONAL FRAMEWORK

A. Statutory Framework

6. **The Companies Ordinance sets primary requirements for financial reporting of all companies incorporated in Pakistan.** The Companies Ordinance requires the preparation, presentation, and publication of financial statements, including disclosures and auditing of all companies incorporated in Pakistan. In addition to the various provisions pertaining to financial reporting, the Fourth Schedule of the Ordinance lays down the form, content, and certain disclosure requirements for preparing financial statements for listed companies, while the Fifth Schedule outlines the same for non-listed companies.¹⁰ It is mandatory for group incorporated companies in Pakistan to prepare consolidated financial statements in accordance with IFRS requirements.¹¹

7. **Under the Companies Ordinance it is obligatory for all companies to present their financial statements in accordance with IAS notified in the government gazette by the SECP.** The Securities and Exchange Commission of Pakistan (SECP) has notified that all IASs except IAS 29 *Financial Reporting in Hyperinflationary Economies* and IAS 41 *Agriculture* are applicable for the listed companies. The International Accounting Standards Board (IASB) has issued and made applicable a number of IFRS, which have not yet been notified by the SECP. As a result, full compliance with SECP-notified standards may not necessarily result in full compliance with IASB-issued accounting

⁷ There are three stock exchanges operating in Pakistan, the largest, Karachi Stock Exchange; Islamabad Stock Exchange; and Lahore Stock Exchange. With a few exceptions, almost all companies registered with the Islamabad and Lahore Stock Exchanges are registered in Karachi Stock Exchange.

⁸ *Annual Report 2004*, Karachi Stock Exchange Ltd.

⁹ Data from the Embassy of the Islamic Republic of Pakistan, USA. www.embassyofpakistan.org

¹⁰ Various provisions of the Companies Ordinance, including the Fourth Schedule have already been revised in compliance with the requirements of IFRS.

¹¹ Section 237 of the Companies Ordinance.

standards. Immediate steps should be taken for notification of all accounting standards and interpretations issued by the IASB till date.

8. **The enforcement of accounting and auditing standards by the Registrar of Companies is largely constrained by inadequate technical capacity.** The Registrar of Companies, which is housed at the SECP, is empowered to enforce provisions of the Companies Ordinance, including inspection of books of accounts. There are 8 Company Registration Offices operating in Pakistan.¹² Only 17 qualified accountants are available in the Registrar of Companies, hardly enough to monitor and enforce the compliance of applicable requirements and standards for about 44,000 companies incorporated throughout Pakistan. Efforts are underway to improve SECP's capacity with respect to qualified accountants.

9. **The Companies Ordinance outlines obligations of company directors with regard to the preparation of annual financial statements.** Company directors are responsible for timely preparation of annual financial statements and present these statements at the annual general meeting of the shareholders. The audited financial statements along with the company directors' report should be filed with the Registrar of Companies within one month of holding the annual general meeting. The directors' report must include several mandatory disclosures. Failure by the director to comply may lead to a fine or imprisonment or both.¹³ However, private limited companies are not mandated to file their audited financial statements with the Registrar of Companies.

10. **There are additional reporting requirements for listed companies.** The Companies Ordinance requires that each listed company prepare quarterly financial statements and file these statements with the SECP, Registrar of Companies, and Stock Exchange. Failure to comply may lead to a fine not exceeding 100,000PKR against a director, including the chief executive officer (CEO) and chief financial officer (CFO). Furthermore, the Company Ordinance grants authority to the SECP to request any additional accounts and reports deemed necessary toward regulating the listed companies.¹⁴

11. **The Companies Ordinance spells out audit requirements for companies incorporated in Pakistan.** Audit requirements include the procedures relating to appointment and removal of auditors, including duties, responsibilities, and obligations in performing audit functions. It is mandatory to appoint a practicing member of ICAP for auditing any public limited companies, including their subsidiaries and private companies with paid up capital of 3 million PKR or more. However, the Ordinance is silent on who can audit other private limited companies.¹⁵

¹² These offices are located in Faisalabad, Islamabad, Karachi, Lahore, Multan, Peshawar, Quetta, and Sukkur.

¹³ Section 236 of the Companies Ordinance.

¹⁴ Section 246 of the Companies Ordinance.

¹⁵ Many stakeholders perceive this legal limitation as a contributing factor for weak monitoring and enforcement of standards for many closely held family companies with a substantial business size.

12. **The Monitoring and Enforcement Department of SECP is responsible for enforcing IFRS compliance by listed companies.** Listed companies are required to comply with SECP requirements with respect to corporate accounting and disclosures. In pursuance of the authority granted under the Companies Ordinance [subsection (3), Section 234], SECP issues special regulatory orders prescribing mandatory IFRS application to listed companies. The Enforcement and Monitoring Department uses a standard checklist format in order to ensure compliance with applicable accounting and disclosure requirements. Strengthening SECP capacity would improve its monitoring and enforcement function.

13. **The Securities and Exchange Commission of Pakistan Act (1997) protects investors and regulates the securities market.** In order to protect investors' interests, SECP issues listing requirements that specify disclosures applicable to listed companies, in addition to other applicable auditing and accounting requirements.

14. **The SECP has mandated the audit committee and the rotation of auditors for listed companies.** The board of directors of every listed company is required to establish an audit committee, comprising not less than three members, including the chairman. The majority membership of the committee is to be drawn from the non-executive directors of the company. The audit committee among its responsibilities makes recommendations to the company's board on the appointment of external auditors, audit fees, and provision of non-audit services by the auditors. Such recommendations require shareholders' approval at the annual general meeting. The SECP has mandated rotation of audit firms for all listed and non-listed banks, non-banking finance companies (NBFCs), modarabas and insurance companies. It has also mandated rotation of audit engagement partners for other listed companies. In both cases, the rotation must be made after every five years.

15. **The Banking Companies Ordinance empowers the State Bank of Pakistan (SBP) to regulate financial reporting by banks and similar financial institutions.** The accounting and auditing requirements as outlined in the Banking Companies Ordinance are in addition to those set by the Companies Ordinance, SECP, and Stock Exchange. The SBP has prescribed formats for financial statements, including disclosure requirements that each bank must follow. Due to the exemption granted to financial institutions from the applicability of IFRS 39 and 40 these formats are deviating from full compliance with IFRS. All banks and development financial institutions (DFIs) must publish audited annual financial statements and file those statements with the SBP within three months of the financial year-end. The financial statements of all banks and DFIs must be audited by the selected qualified auditors from the list empanelled with SBP.¹⁶ Exercising the authority conferred by Section 35(3) of the Banking Companies Ordinance, SBP issues guidelines for the auditors, primarily for the purpose of prudential regulations. Bank auditors are required to hold meetings with the SBP inspectors before commencement of their on-site inspection. Also inspectors are required to share their concerns with the respective auditors

¹⁶ In preparing the panel of audit firms, SBP considers the size of the firm, its audit experience, and ICAP-rated quality control. There are three categories of paneled audit firms: Category A can conduct audits of all banks and DFIs; category B can audit the banks and DFIs with total assets (net of contra items) up to 50 billion PKR or having up to 99 branches; and category C can conduct audits of the banks and DFIs with total assets (net of contra items) below 5 billion PKR or having below 10 branches.

upon completion of the inspection. Furthermore, the auditors are required to send copies of the Management Letter and any other letters to bank management; and to the SBP within one week of issuance of such letters.

16. **In compliance with SBP requirement, banks and similar financial institutions publish their quarterly financial statements in newspapers.** Through a circular issued in 2004, the Banking Supervision Department of the SBP has made it mandatory for all banks and DFIs to publish their unaudited quarterly financial statements and limited audit reviewed half-yearly financial statements in a newspaper.

17. **The Insurance Ordinance of 2000 regulates the financial reporting practices of insurance companies.** Insurance companies, operating in Pakistan must comply with the requirements of the Insurance Ordinance 2000 in preparing and presenting their financial statements. The Ordinance empowers the SECP to monitor and enforce the applicable laws and standards, including the accounting and auditing for the insurance companies. The audit functions of insurance companies must be carried out by an ICAP member. The auditor is appointed from the SECP-approved panel. The audited financial statements of insurance companies should be submitted to the SECP within 4 months of the financial year-end. As per the Insurance Ordinance, the actuarial certification must be obtained whether the insurer's reserves adequately meet all liabilities.

18. **The Non-Banking Financial Companies Department of SECP regulates the non-banking financial institutions in Pakistan, including their accounting and reporting.** This department is responsible for regulating investment banks, leasing companies, discount houses, housing finance companies, and venture capital companies. It is authorized to monitor and enforce the accounting and auditing requirements for the non-banking financial institutions as set by the Non-Banking Finance Company Rules 2003. The financial statements of the non-banking financial institutions must be audited by the ICAP member.

19. **The Stock Exchange Listing Rules require all listed companies to present interim financial statements.** The Stock Exchange Listing Rules require all listed companies to publish unaudited quarterly financial results, according to a prescribed format, and be circulated among the shareholders along with directors' review on the quarterly affairs of the listed company. These quarterly financial statements do not require auditing, while the half-yearly financial statements are subject to a limited scope review by the professional auditors.

20. **Tax law entails companies to submit audited annual financial statements with their tax returns.** The Income Tax Ordinance 2001 requires companies to submit their audited annual financial statements along with the annual tax return. The companies derive corporate income for tax purposes after adjusting relevant figures from their general purpose financial statements, as per applicable provisions and allowances under the Income Tax Ordinance.

21. **Certain laws and regulations in Pakistan call for taking into account some Islamic tenets in corporate accounting and auditing.** The Government of Pakistan has

put in place various legislative enactments in order to take into account the application of Islamic doctrines in preparation and presentation of financial statements. Such enactments include ordinances for regulating the financial reporting practices of Modaraba companies¹⁷ and incorporating auditors' opinion with regard to payment of zakat.¹⁸ Moreover, the SBP is in the process of formulating a separate set of prudential regulations for the Islamic banks operating in Pakistan. Islamic banks with 1-2 percent of the total assets do not constitute a significant part of the banking sector.

22. Federal laws covering state-owned enterprises (SOEs) authorize the Controller General of Accounts to regulate SOE accounting functions and the Auditor General of Pakistan to conduct SOE audits. The Controller General regulates the accounting and reporting functions of the SOEs, while the Auditor General is responsible for their audit functions. However, ICAP members, in addition to the Auditor General, will conduct audits of SOEs, which are incorporated under the Companies Ordinance.¹⁹ The audit conducted by the Auditor General's office primarily focuses on compliance of rules in carrying out financial management of those enterprises. The government personnel responsible for providing guidance on accounting functions and conducting auditing of the SOEs largely lack exposure of relevant public sector accounting and auditing pronouncements of the IFAC. Nevertheless, the corporatized SOEs are making efforts to align their accounting and auditing in line with international standards.

23. In pursuance of the Companies Ordinance, SECP has mandated the cost audit in certain sectors. In pursuance of the provision of Section 258 of the Companies Ordinance, the SECP has mandated the cost audit for the listed companies involved in cement, sugar, edible oil products, and processing. The cost audit entails preparation of statements with regard to production capacities and inventories.²⁰ These statements are

¹⁷ Modaraba represents a form of partnership where one party provides the funds while the other party provides expertise and management. Any profits accrued are shared between the two parties on a pre-agreed basis, whereas the loss is borne by the provider of the capital. According to the Financial Sector Assessment Report 2003 of the SBP, the Modaraba sector has shown a declining share in total assets in the FY2003 despite the fact that Modarabas constitute the largest group in the non-banking financial institutions of Pakistan. The Modaraba companies are regulated through the Modaraba Companies & Modarabas (Flotation & Control) Ordinance 1980.

¹⁸ Zakat is a form of giving to the people who are less fortunate. It is obligatory for all Muslims to pay 2.5 percent of their wealth and assets each year. The Government of Pakistan has promulgated the Zakat and Usher Ordinance 1980 to administer the zakat. Section 255 of the Companies Ordinance requires that auditors must include in their reports whether or not zakat was deducted by the company and deposited it in the central zakat fund.

¹⁹ In a 1968 circular, the Government of Pakistan mandated that the appointment of chartered accountants as auditors for the SOEs should be rotated once every five years. However, there are no other criteria for appointment of SOE auditors. There exists some confusion about the role of the Auditor General of Pakistan in conducting SOE audits. For example, the Pakistan Telecommunication Company Ltd (PTCL), a majority state-owned enterprise, refused to allow the Auditor General to audit on the grounds that such audit should be conducted according to the Companies Ordinance. The Auditor General contends that his department is responsible for the PTCL audit in accordance with the provisions of the Constitution of Pakistan.

²⁰ These statements include (a) a statement of production capacity of the plant delineating between machine hours and production units, actual capacity utilization, and reasons for any variance thereof; and (b) a statement of inventory as at the financial year-end in terms of quantity and cost distinguishing between inventory of raw materials, work-in-progress, and finished goods.

required to be signed by the CEO and CFO of the company. The members of ICAP and the Institute of Cost and Management Accountants of Pakistan (ICMAP) are eligible to perform the cost audit functions. Within 60 days of appointment, the cost auditor is mandated to finalize the report and submit it to the SECP. The company is required to submit an explanation to the SECP with regard to any audit qualification within 30 days of submission of report by the cost auditor.

B. The Profession

24. **The self-regulated Institute of Chartered Accountants of Pakistan oversees the accountancy profession in Pakistan.** The ICAP was established by the Chartered Accountants Ordinance in 1961. The Government of Pakistan (GoP) is in the process of revising the current ordinance. The revision includes, among others, vesting more power to the ICAP for taking disciplinary actions against its members for violating code of ethics and professional norms. This professional body was modeled on the Institute of Chartered Accountants of England and Wales. ICAP acts both as an examining body for awarding chartered accountancy qualifications and the licensing and disciplinary authority for members engaged in public practice. ICAP is a member of the International Federation of Accountants (IFAC), South Asia Federation of Accountants (SAFA), and Confederation of Asia Pacific Accountants (CAPA). The ICAP membership is 3,377 (July 2004 figures) of which about 17 percent are engaged in public practice.

25. **The ICAP Council, assisted by various committees of volunteer members, governs organization.** The Council is the supreme body through which the ICAP functions and is comprised of 12 elected members and 4 persons nominated by the Federal Government. The major statutory functions of the Council include designing and implementing policies regarding student enrollment, including administering education, training, and examination; programs for members' professional development; ensuring adherence to professional ethics and standards; and disciplinary action against erring members. The Council elects the ICAP president, who also becomes the chief executive officer, to a one-year term.

26. **The ICAP allows its practicing members to associate with two audit firms.** The by-laws of the Chartered Accountants Ordinance 1961 allows its members, while already in practice under a sole proprietorship firm, to join as a partner in another audit firm. Various stakeholders perceive that such an arrangement may promote "sleeping" partners—joining a firm in name only without actual work—to meet firm-size limits in order to gain business.

27. **The ICAP has set the minimum fee for conducting audits.** Like many other countries, audit fee is a sensitive issue. Auditors often complain about the low audit fee in Pakistan. ICAP has prescribed a minimum fee schedule, which members are required to follow in rendering audit services.

28. **The Institute of Cost and Management Accountants of Pakistan is actively involved in financial reporting process and cost audit.** The ICMAP is an autonomous body established in 1966 with a similar governance structure to the ICAP. The total

number of members of this professional body is 2,190 (July 2004 figures). Most ICMAP members work in industry and are involved in the preparation of corporate financial statements. In addition, some ICMAP members provide cost audit services to companies falling within certain manufacturing industry sectors (as described in Para 23).

29. **There are cases when management tends to shift the responsibility for preparing financial statements on the auditors.** Some stakeholders, including auditors, have cited few instances when company management has either partly or fully shifted the responsibility for preparation of financial statements on the auditors. This may be due to the lack of qualified professionals available for preparing financial statements and corporate management's misperception about the role of auditors. The latter point arises from company directors' lack of knowledge on auditing procedures, thus impairing significantly their fiduciary responsibility. In order to be compliant with the independence rules, auditors should not audit the financial statements that they prepare. Preparation of financial statements is the responsibility of corporate management.

30. **The large international accounting firm networks have strong presence in Pakistan.** The local members/affiliates of international accounting firm networks audit about 40 percent of the listed companies, leaving the remaining market share to the local firms. The internationally affiliated firms audit most of the banks and insurance companies. Three local audit firms have undertaken about 20 percent of listed companies' audit. Several local firms have established network in major cities of the country.

31. **Members of the ICAP are required to follow the Code of Ethics.** The ICAP Code of Ethics for Chartered Accountants was revised in 2003 in line with the IFAC Code of Ethics for Professional Accountants, which was issued in November 2001. The ICAP must implement an effective mechanism to enforce this Code. More stringent disciplinary actions and effective periodical audit for members are necessary to monitor for detecting ethical misconduct or violations.

32. **The ICAP lacks adequate technical resources.** The ICAP is dependent on volunteer members and should reduce this need by employing adequate full-time qualified personnel. Increasing the technical resources will help the ICAP in better discharging its IFAC membership obligations, including supervision of members and implementing ethical standards and disciplinary procedures.

33. **Professional indemnity insurance is not required by law.** Some practicing auditors who work for affiliates of international accounting firm networks in Pakistan are covered by professional indemnity insurance. While auditors are subject to civil liability, they are not required by law to take professional indemnity insurance. This has created an environment of unconcern toward risks of malpractice suits by auditors in many cases. Professional indemnity insurance is not a well known concept in Pakistan. Most insurance companies do not have this product. However, it is possible to obtain professional indemnity insurance coverage at an exorbitant price which seems to be beyond the capacity of most of the audit practitioners in Pakistan.

34. **Many stakeholders perceive that auditors' involvement in both audit and tax advocacy may threaten auditor independence.** In Pakistan statutory auditors are not specifically prohibited from providing some non-audit services, including tax advocacy and representation before tax authorities²¹. There is a strong perception among the various stakeholders that such involvement may pose a threat to auditors' independence.

35. **One of the British professional accountancy bodies has a discernible presence in Pakistan.** There is a perception among the stakeholders that the professional qualifications for the Association of Chartered Certified Accountants (ACCA) of the United Kingdom are becoming increasingly popular in Pakistan, primarily due to its international marketability. The ACCA membership is 779 (December 2004 figures). A qualified ACCA member is entitled to obtain exemption from the foundation courses in the ICAP professional examination. There is a tendency among some of the aspiring accountants to obtain both ICAP and ACCA professional qualifications.

C. Professional Education and Training

36. **ICAP follows a modular approach in conducting the education and examination of professional accountants.** The curriculum consists of six modules covering 21 subjects spread over three levels: foundation, intermediate and professional. Each student before registering with ICAP is required to pass the Pre-Entry Proficiency Test. The minimum qualification for entering students is a Higher Secondary Certificate (or A levels). Bachelor's degree holders and post-graduates, with a defined minimum score, are exempt from the Pre-Entry Proficiency Test.²² Upon passing the Pre-Entry, students register with ICAP for the foundation level and get tutorial supports from any of the ICAP registered accounting training centers. A student cannot advance to the next higher level without passing the previous level. There is no limit on the number of attempts that the students can make in order to pass the examination.

37. **Practical training is a prerequisite for the ICAP membership.** Prior to obtaining full ICAP membership, a candidate is required to have four years of practical training under the guidance of a qualified chartered accountant.²³ This training requirement starts after completing foundation-level curriculum. In order to guide trainee students, a chartered accountant must be in practice for minimum of three years with audit experience in 25 entities. There is a general perception that the range and depth of practical knowledge gained in training varies with the size of accountancy firms that act as training provider. However, the current system of monitoring the quality and ability of practical training providers is sometimes constrained by the lack of adequate ICAP resources²⁴.

²¹ An ICAP appointed committee has reviewed this in line with IFAC requirements and presented its recommendations to the SECP for its approval.

²² This includes first division bachelors degree holders and post-graduates with second division.

²³ ICAP is considering revising this requirement of training period bringing down it to three and a half years.

²⁴ ICAP has recently introduced new training regulations, which are largely in line with IES 5 '*Practical Training Requirement*'.

38. **ICAP has set mandatory continuing professional education requirements.** Currently ICAP members are required to accumulate 25 credit hours of continuing professional education. From July 2005 this requirement will increase to 30 credit hours and from July 2006 onwards it will be 40 credit hours in one year or 120 credit hours in total in three years. However, ICAP needs to strengthen its mechanism with regard to the enforcement of continuing professional education as a requirement of professional membership so that the qualified professional accountants gain up-to-date knowledge on recent developments in financial reporting, auditing, and other related topics.

39. **Professionals working in small accountancy firms find it difficult to stay updated on recent developments in accounting and auditing.** These practitioners are constantly struggling to keep their client base and earn enough to stay afloat. In most cases, they do not have the money and time for training programs. Many practitioners in small- and medium-size firms in Pakistan are also handicapped by their lack of access to current literature on the applicable accounting and auditing standards. Such a situation may limit the quality of auditing in the country.

40. **The trainee accountants cannot cope with the stipend they receive during their training period.** The trainee stipend is based on a scale prescribed by the ICAP and correlated with the passing of different modules. Minimum monthly stipends prescribed by ICAP ranges from 1,750 PKR (less than US\$30) to 5,000 PKR (approximately US\$83). By comparison across the country, a newly qualified chartered accountant's salary ranges from US\$700 to US\$1,000 per month.

41. **Many entrants to the profession lack adequate knowledge in English and communication.** In opinions expressed to the ROSC team, many stakeholders felt that entrants lack adequate knowledge in English with adverse affects on the quality of their work. Although ICAP-sanctioned instruction is in English, in order to adequately prepare students, ICAP training arrangements should focus on interpersonal and communication skills and skills in forming professional judgments, in parallel with development of technical and functional skills.

42. **University courses in accountancy do not focus on teaching IFRS or ISA.** The institutions of higher learning in Pakistan do not focus on IFRS and ISA in their bachelor's and graduate degree programs in accountancy. The curricula are mainly restricted to teaching accounting technicalities and basic procedural aspects of auditing. Thus the students do not obtain required exposure of international best practices with regard to accounting and auditing. Moreover, most accounting textbooks, used for teaching lack adequate focus on the international dimension of accounting and auditing.

43. **Both academic and professional education in accounting lack adequate coverage on professional values and ethics.** Formal education can significantly enhance aspiring accountants' awareness of ethical problems and can influence their reasoning and judgment with respect to ethical dilemmas. For this reason, the IFAC recommends teaching professional ethics separately in the prequalifying education of professional

accountants.²⁵ However, in Pakistan, neither the academic institutions nor the professional accounting bodies provide adequate coverage on ethical dimensions in their curricula. ICAP teaches business ethics as part of other courses while professional ethics is not taught as a separate subject.

44. ICAP examination is not in full conformity with IFAC education standard. Based on responses to questions and interviews with various stakeholders, the ROSC team resolved that ICAP examination focuses more on academic and technical knowledge-related aspects than on practical issues of IFRS and ISA, including the judgment to be exercised by auditors in real-life circumstances. Such knowledge testing of aspiring accountants does not comply adequately with IFAC requirements²⁶ and fails to provide ample assurance that certified accountants have the required professional skills to carry out independent audits successfully.

D. Setting Accounting and Auditing Standards

45. With the recommendation of ICAP, SECP adopts IFRS in Pakistan. SECP promulgates accounting standards in Pakistan based on the recommendations of ICAP.²⁷ After completion of the due process when IASB issues a particular standard, the ICAP starts its own due process. On receipt of the final standard from the IASB, the Professional Standards and Technical Review Committee of ICAP reviews the standard and recommends whether the ICAP Council forwards it to the SECP. Having deliberations in the Council, ICAP advises the SECP to adopt the particular standard. Once adopted by SECP through official notification in the government gazette, the standard becomes mandatory for observance by the companies. The adoption process in Pakistan adheres to total adoption of IFRS.

46. ICAP adopts International Standards on Auditing as national standards. ICAP issues ISA for mandatory observance by its members. Upon receipt from the IFAC, the exposure draft is sent to ICAP members for comments. These comments are returned for consideration by IFAC. When the final standard is issued, ICAP adopts the standard. The ISAs are adopted in Pakistan without any modification.

47. Lack of adequate number of qualified professionals and lengthy due process encumbers timely adoption of new IFRS and incorporation of any subsequent revisions. Currently ICAP lacks fulltime qualified professionals for undertaking efforts in effectively facilitating the standards setting process.²⁸ At present SECP also takes a long

²⁵ IFAC International Education Standard (IES) 4, *Professional Values, Ethics, and Attitudes*. IFAC Educational Guideline No. 10, *Professional Ethics for Accountants: The Educational Challenge and Practical Application*.

²⁶ IFAC International Education Standard (IES) 6, *Assessment of Professional Capabilities and Competence*, which states, *inter alia*, that the examination should “require a significant portion of the candidate’s responses to be recorded form” and “cover a sufficient amount of the whole range of professional knowledge, professional skills, and professional values and attitudes”.

²⁷ However, there is no legal obligation on the part of SECP to seek recommendation from the ICAP in adopting IFRS.

²⁸ Since SECP relies on professional advice from the ICAP in promulgating standards, it is important that ICAP have adequate qualified personnel in facilitating the standard setting process.

time to complete its official endorsement process after receiving inputs from ICAP. These factors attribute in hindering timely adoption of new standards, including incorporating changes in the existing standard in line with IASB pronouncements.

E. Ensuring Compliance with Accounting and Auditing Standards

48. **The SECP reviews financial statements of selected listed companies for monitoring compliance with international standards; however its effectiveness is constrained by lack of technical expertise.** The SECP reviews financial statements of listed companies. Upon identification of violations of established accounting and disclosure requirements, SECP is authorized to initiate punitive actions against both preparers and auditors. So far SECP has identified few cases of noncompliances that draw such sanctions as issuing letters of admonition and levying fine. Despite some success in monitoring and enforcement a few years ago when this mechanism was launched, at present a shortage of technically qualified human resources makes it difficult to conduct proper monitoring activities. In essence, lack of adequate technical capabilities limits full investigation by SECP in cases when material noncompliances might have taken place. However, the SECP continues its efforts to increase the number of qualified accountants and to improve its monitoring and enforcement capacity.

49. **No effective mechanism exists to enforce requirements of accounting and financial reporting for the nonlisted companies.** The enforcement mechanism for accounting and financial reporting of nonlisted companies is virtually nonexistent in Pakistan. Absence of mandatory filing of annual financial statements with the Registrar of Companies by the private limited companies makes it almost impossible to review the level of compliances. The Companies Ordinance is also unclear on who can audit the private limited companies with paid up capital of below 3 million PKR. Furthermore, SECP lacks adequate technical capacity to identify accounting and auditing violations.²⁹

50. **The Stock Exchanges in Pakistan do not undertake monitoring and enforcement activity with respect to accounting and auditing standards.** Listed companies are required to submit their financial statements to the Stock Exchange. The Stock Exchanges in Pakistan are satisfied with the timely issuance of audited financial statements by these companies, without having any arrangement in place to systematically carry out monitoring of compliance with the applicable accounting and financial reporting requirements.

51. **Financial statements prepared by insurance companies need effective monitoring and enforcing actions.** The Insurance Ordinance 2000 vested power in the SECP to regulate the financial reporting of insurance companies. In reality, SECP lacks technical capability to exercise these powers.

52. **The SBP's Department of Banking Supervision needs to enhance its technical capacity in monitoring and enforcing accounting and financial reporting requirements.** Primarily to ensure compliance with prudential regulations, SBP officials conduct both offsite and onsite supervision of banks and DFIs. With respect to the general

²⁹ Refer to paragraph 8.

purpose financial reporting by these institutions, SBP examines financial statements, approves the appointment of statutory auditors, reviews any communication from the statutory auditors, and holds meetings between banking supervision staff and a bank's statutory auditors. In the recent past, there are few instances when the SBP has taken punitive measures against auditors for noncompliances.³⁰ However, there is still a need for enhancing SBP's technical capabilities, particularly in terms of practical application of accounting and auditing standards, with regard to monitoring and enforcement of financial reporting requirements.

53. As a self-regulator, ICAP introduced the Quality Control Review (QCR) of audit firms. An independent review mechanism can ensure that audit firms have adequate quality control arrangements in place for compliance with IFAC requirements of quality assurance of audit firms. In 1987, ICAP introduced QCR, under the guidance of a committee drawing all of its membership from ICAP. Recently, ICAP converted this committee into a board, where it has included representative from the Central Board of Revenue (CBR), Karachi Stock Exchange (KSE), SBP, Auditor General, and Accountant General offices. Efficiency of the QCR is constrained by non-availability of adequate number of experienced reviewers. The ICAP publishes results of the quality review naming the audit firms. Based on the review, either a 'satisfactory' or 'nonsatisfactory' certification is given. As of 28 February 2005; 95 practicing accounting firms in Pakistan got 'satisfactory' rating³¹ and their names were published in the ICPA's website. However, the website does not mention the name of the firms, who obtain 'nonsatisfactory' rating. During the period between July 2003 and June 2004, QCR of 30 practicing accounting firms were conducted and out of which 5 cases were referred to the ICAP's Investigation Committee for their "prima facie negligence"³² In accordance with the SECP requirement, an audit firm receiving a nonsatisfactory certification cannot audit listed companies. Nevertheless, such reviews should not rule out instituting a system of independent oversight of audit profession in Pakistan. Moreover, putting in place an arrangement of independent oversight will enhance stakeholders' confidence with regard to accounting and auditing practices in the country. Recently the ICAP has also launched a Financial Statements Review (FSR) Program, under which it is planning to review the financial statements of all listed companies in order to determine compliance with applicable standards.

54. The slow legal process often discourages regulators from taking legal recourse in enforcing compliance with financial reporting requirements. Generally, the process of adjudicating cases in Pakistan is slow. Regulators are often discouraged from taking legal action when enforcing sanctions against violators. Furthermore, the penalties specified in the Companies Ordinance for various noncompliances, in many cases, are not commensurating with the nature and magnitude of the offences.

55. Nonavailability of implementation guidance is constraining full compliance of accounting and auditing standards. In Pakistan, neither the professional nor other

³⁰ This includes downgrading the audit firm from higher to the lower category and barring the audit firm from conducting bank audit for a certain period of time.

³¹ See www.icap.org.pak

³² The Institute of Chartered Accountants of Pakistan Annual Report 2004, p. 14.

organizations issue guidance on implementation of IFRS and ISA. This has contributed, in some cases, to the knowledge gap among preparers and auditors of financial statements. Consequently, it raises a possibility of applying the standards in inconsistent manner and resulting in the compliance gaps between IFRS and ISA requirements and actual practices. Lacking access to modern audit practice manuals, many audit practitioners are unable to deal with important concepts, such as audit risk, audit planning, internal control, materiality, documentation, going concern and quality control. With ICAP-implemented guidance, the auditors can audit with applicable rules and standards. This guidance should incorporate cases and illustrations, relevant to Pakistan focusing on industry-specific experiences.

III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

56. With the adoption of IFRS, Pakistan has attempted to close the gap between local and international standards. Pakistan has adopted most of the applicable IAS/IFRS, except IAS 29, *Financial Reporting in Hyperinflationary Economies*, and IAS 41, *Agriculture*. Although adoption of most IFRSs has tended to close the gap between local and international standards, lack of uniformity in application still risks a gap between IFRS and actual practice.

57. The application of IFRS is sometimes influenced by taxation consideration. The ROSC team found instances where preparers of general purpose financial statements departed from IFRS and followed tax rules in choosing the method of accounting treatment. For example, some companies' IFRS-based financial statements reported finance lease as operating lease. The companies sometimes manage their profits in order to minimize taxation liabilities, an approach that is noncompliant with IFRS. However, the auditors of these companies did not qualify their audit opinion referring this issue.

58. The deferral of implementing IAS 39 by the State Bank of Pakistan has restricted full compliance with IFRS by the banks and similar financial institutions. The SBP has deferred application of IAS 39 for banks and DFIs until December 2006³³. Deferment of IAS 39 has created differences in accounting treatment in certain areas by the banks, which among others, lead to noncompliances primarily with respect to adoption of fair value, and treatment of gains and losses of derivative contracts.

59. The mandatory application of all IFRS for all companies tends to burden the small and medium-sized enterprise (SME). Given the substantial increase and complexities of IFRS, it is not possible for SMEs to ensure full compliance with all the requirements of IFRS. In reality, these SMEs do not have adequate technical capabilities and resources to ensure compliance with complicated reporting requirements.

³³ The deferment of implementing IAS 39 was on the basis of recommendation of a joint committee comprising representatives of banks, ICAP, and SBP.

60. **Despite significant improvements in corporate financial reporting practices in Pakistan in recent years, there still exists evidence of “compliance gaps.”**³⁴ The World Bank ROSC team reviewed the IFRS-based financial statements of 53 listed companies. Some financial statements had a high degree of compliance, while several cases of accounting policies, presentations, and disclosures failed to comply fully with IFRS requirements. The tendency was to demonstrate compliance in form rather than in substance. In addition to the sample reviews, facilitated discussions held with experienced corporate accountants, academics, professional auditors, and financial analysts indicated several areas, where the actual practices diverge from the applicable standards. Examples of some deficiencies found in the reviewed IFRS-based financial statements include the following:

- **Inventory valuation.** Failing to follow all requirements related to measuring and disclosing inventories at the lower of either cost or market value.
- **Segment reporting.** No adequate disclosure of information focusing on both business and geographical segments.
- **Revenue recognition.** Nonadherence of applicable accounting policy on revenue recognition, for instance, in case of installment sales revenue was recognized on a cash basis rather than accrual basis.
- **Related party transaction.** Not disclosing the nature and extent of control by the related parties.
- **Investment property.** Land and buildings meeting the criteria of investment property are generally classified as fixed assets and recorded at cost minus accumulated depreciation; instead of using either the cost or fair value model as prescribed by IAS 40.
- **Disclosure and presentation of preference shares.** Preference shares issued by banks, irrespective of conditions contained in the issue have been shown as part of equity, instead of classification as financial liability.
- **Effects of changes in foreign currency translation.** Nonadherence to requirement that foreign currency exchange gains or losses arising from balance sheet date revaluations should be shown in the income statements.
- **Property, plants, and equipment.** In case of revaluation of fixed assets, detailed disclosure was not made. Also showing the major costs of improvement in fixed assets as an expense, instead of capitalization. Furthermore, it appeared that in calculating depreciation of assets, useful life was not properly taken into account.
- **Accounting for leases.** Treating finance lease as operating lease and not adhering to the IFRS requirement of valuation of finance lease using the present value of future cash flows.
- **Employee benefits.** Not recognizing the liability for employee benefits on accrual basis. Moreover, nondisclosure as to whether actuarial or any other forms of valuation had been made to quantify outstanding liabilities for post-employment benefits.
- **Deferred taxation.** Not disclosing the tax effects related to assets that were revalued to the amount in excess of the historical costs or a previous revaluation.

³⁴ Compliance gaps refer to the deviation of actual practice from the applicable accounting standards.

- **Impairment of assets.** Not undertaking impairment tests of tangible and intangible assets on the balance sheet date.
- **Earning per share.** Using different interpretations on how to provide supporting data on calculation of basic earnings per share and diluted earnings per share.
- **Additional disclosure by banks.** No disclosure of aggregate amounts included in the balance sheet for loans and advances on which interest is not being accrued. Also nondisclosure of classification of assets into long and short term.

IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

61. To better understand the actual auditing practices, the ROSC team interviewed practicing auditors and experienced accountancy professionals and had facilitated discussions with the partners representing large and medium-sized audit firms.

62. **Adoption of International Standards on Auditing has closed the standard gap; however, the application of these standards differs among various audit firms.** In many cases, auditors do not follow risk-based approach focusing on critical assertions. The large firms and some medium-sized firms are better equipped to apply international standards. Many firms are unable to comply with ISAs when faced with unaffordable expense of skills development. Also various stakeholders opined for increased audit supervision by audit partners and senior staff which would lead to improving uniform application of auditing standards.

63. **Despite some auditors have qualified their audit opinions, it is more common to issue “subject to/except for” audit opinions with a list of observations.** The ROSC team found cases, where auditors gave qualified opinion in the audit report. However, in most cases, auditors tend to avoid “adverse or disclaimer” opinions and prefer to issue “subject to/except for” audit opinions together with a list of audit observations, appearing either in the audit report or in notes to accounts. These inappropriately qualified opinions can mislead or confuse the users of the financial statements. This is an apparent violation of IFAC-issued ISA 700, *Auditor’s Report on Financial Statements*, which states that auditors should take into account collective effect of all the qualifications in preparing their audit opinion on “true and fair view.” Instead of conveying apparently positive opinions, subject to one or more observations, the auditors should provide disclaimers or adverse opinions, where appropriate, for ensuring compliance with applicable auditing standards, as well as providing a clearer understanding to users.

64. **Lack of understanding by directors and members of the management about the purpose of audits sometimes makes it difficult for auditors to obtain appropriate audit evidence.** Many auditors claimed that some directors and members of the top management often fail to appreciate adequately the purpose and value of auditing. However, such a situation limits access to evidence to form professional judgments. Despite the arduous efforts by some auditors to carry out audits as per international standards and best practices, they view this situation as a major constraint in discharging their professional responsibilities.

V. PERCEPTION OF THE QUALITY OF FINANCIAL REPORTING

65. **There have been recent qualitative changes in financial reporting, however further improvements are needed.** Financial reporting practices are generally perceived to have improved significantly over the past years; although the need for strengthened enforcement mechanisms exists in order to achieve further improvement of quality in corporate financial reporting. Discussions with various institutional investors, regulators, financial analysts, bankers, and academics revealed that the corporate financial reporting regime has experienced significant improvements in Pakistan over the past 4 to 5 years. Contrary to this, stakeholders also expressed their concerns with audit quality, in particular, the issue of independence of many practicing auditors. They strongly agreed that strengthening enforcement mechanisms would help ensure compliance with IFRS and ISA, auditors' independence, and adherence to the professional code of ethics. Many stakeholders in Pakistan feel that strengthened enforcement mechanisms would better utilize the available professional capabilities of accountants, many of whom are capable of producing financial statements of an international standard.

66. **Many stakeholders commended regulators' role during recent years for improving the quality of financial reporting.** A majority of the interviewed stakeholders praised the initiatives undertaken by the SECP, SBP and ICAP geared toward improving the quality of financial reporting in Pakistan. Stakeholders viewed that mandatory application of IFRS, monitoring and enforcement of standards and introduction of QCR were important steps toward establishing a sound corporate financial reporting regime. For further improvement in enforcement process, most regulators and some professionals agreed to the need for creating independent oversight for the auditing profession, in line with recent developments in many developed and emerging market economies. During ROSC-facilitated discussion with a sample of audit firms and other stakeholders, there was a broader agreement that adherence to audit standards and code of ethics varied across the levels of profession.

VI. POLICY RECOMMENDATIONS

67. The policy recommendations outlined in this section emerge from the review of accounting and auditing practices in Pakistan, as well as the valuable inputs received from the various stakeholders. These primarily principle-based recommendations are expected to provide inputs in preparing a detailed Country Action Plan geared toward the sustainable high-quality corporate financial regime in Pakistan. The recommendations are aimed at the country's implementation authorities. The following have been taken into account while designing the policy recommendations:

- Building on current achievements so that the implementation of reform will strengthen the system toward achieving high-quality corporate financial reporting.

- Achieving greater financial transparency in the corporate sector and limiting tax evasion through ensuring proper calculation of corporate profits.
- Promoting a gradual process of improvement, whereby the public interest entities will lead the reform process.³⁵
- Strengthening the country's financial architecture aimed at reducing the risks of financial market crises and their allied negative impacts.

68. **Strengthen the monitoring and enforcement mechanism.** High-quality financial reporting cannot be ensured alone by adopting international standards. To a large extent, the quality depends on the designing and implementation of proper monitoring and enforcement system. There are three crucial links in the enforcement process, and each must be strengthened. First, company directors with legal obligations to prepare the financial statements must ensure that accounting staff apply standards properly. Second, statutory auditors must discharge their professional responsibilities independently in order to provide assurance that financial statements comply with all applicable standards and portray “true and fair” view of enterprises’ conditions and results of the operations. Third, both self-regulatory organizations and statutory regulators must ensure proper compliance with the standards and consistently take actions against violators. To ensure effective enforcement, the regulators in particular, need adequate capacity, authority, and independence. Since they cover a wide range of sophisticated and complicated activities, their actions should not be constrained by lack of appropriate human and financial resources. Having taking into account that the monitoring and related activities launched by SECP a few years ago resulted in a significant improvement in the quality of financial reporting by the listed companies, further improvements can be expected to result from increased efforts to enforce the applicable standards. Pakistan has already made progress in the enforcement process, this need to be consolidated by further strengthening the enforcement mechanism through increasing capacity of the regulators and granting them more authority in dealing with infractions of accounting and auditing standards.

69. **Take steps for improving the capacity of regulators.** Generally ineffective regulatory regimes provide a false sense of security to stakeholders; therefore, it is important to strengthen the capacity of the regulators. The SECP and SBP should further strengthen their capacities to conduct in-depth review of corporate financial statements for determining the degree of compliance with the applicable standards, not only in appearance but also in substance. Capacity improvement of these regulators should focus on recruiting technically qualified personnel, practical training on implementation of IFRS and ISA, and providing administrative support and logistics arrangements. Furthermore, these regulators should be independent and should have enough authority to impose administrative sanctions for infractions.

³⁵ Public interest entities may be defined by the nature of their business, size, and number of employees; or by their corporate status by virtue of their range of stakeholders. Examples may include listed companies, banks and similar financial institutions, insurance companies, and large enterprises. The large enterprises may be defined as individual enterprises and groups of enterprise that meet any two of the following three thresholds should be considered as public interest entities: (a) total number of employees exceeding [a number to be decided in consultation with the country stakeholders]; (b) total assets on the balance sheet exceeding [amount to be decided in consultation with stakeholders]; and (c) total turnover exceeding [amount to be decided in consultation with stakeholders].

70. **Introduce an arrangement for independent oversight of the auditing profession.** Auditors have distinct obligations to all stakeholders, including shareholders, regulators, and public at large, to ensure that the financial statements are prepared in compliance with applicable standards and best practices. Discharging this obligation in an appropriate fashion contributes significantly in strengthening Pakistan's financial architecture, including an enhanced confidence of investors. In view of recent worldwide developments in regulating the auditing profession, there is a need for reviewing the current ICAP-instituted system of quality review of auditors. Indeed, there is a growing realization among the international community that the audit profession's self-regulatory arrangements and authority to impose sanctions should be balanced with adequate and independent oversight system. Any independent oversight arrangement should be focused on developing nascent quality assurance system to ensure that auditors comply with all applicable auditing and ethical standards and independence requirements. It should work independently of the audit profession and have ample authority to impose appropriate sanctions. Since the SECP's mandate includes monitoring and regulating compliance with international standards in financial reporting and auditing, the proposed independent oversight arrangement would, in Pakistan's case, be best located within the Commission as one of its core independent activities. The oversight of audit profession may be consolidated with current activities of SECP concerning monitoring and enforcement of corporate financial reporting requirements.

71. ***“Financial Reporting Oversight Unit” may be established within the organizational framework of SECP.***³⁶ An advisory committee may be formed to guide activities of this unit. The advisory committee may consist of experienced professionals and high level representatives of relevant institutions. Main activities of the oversight unit would include the following:

- **Audit Practice Review.** Specialists of the oversight unit will be responsible for conducting practice reviews of the auditors of public interest entities, ensuring each firm is reviewed at a reasonable regular interval. After completion of first time review, recommendations should be provided to the audit firms for overcoming detected shortcomings concerning quality assurance arrangements. The practice review should evaluate an audit firm's quality assurance arrangements, its audit approach, and the working papers with regard to selected audit engagements. Robust practice review methodologies should be developed by the oversight unit in collaboration with the ICAP.
- **Review of financial statements.** SECP's current activities concerning monitoring and enforcement of applicable accounting standards should be brought under purview of the oversight unit. This is mainly because non-compliance with applicable accounting standards, specifically in the areas of recognition and measurement, can be better understood by accessing audit working papers. From this perspective, it is important that the review of financial statements to monitor compliance with accounting standards is linked with the audit practice review work.

³⁶ The participants in a dissemination workshop held in Islamabad on November 17, 2005 unanimously agreed to have an arrangement for independent oversight of the audit profession.

- **Investigation.** Valid complaints against auditors and audit firms, and any irregularities identified from the reviews of financial statements and audit practices should be investigated.

- **Disciplinary power.** Following reviews, steps should be taken for appropriate sanctions on audit firms for preventing noncompliance with auditing requirements. The oversight unit may *inter alia* have the powers to issue warnings, impose fines and penalties, and restrict particular auditor(s) from carrying out statutory audit of public interest entities.

72. **Strengthen capacity of ICAP.** The governance structure of ICAP needs to be strengthened in line with recent international developments for regulating the accountancy profession and role of professional bodies. In this regard, necessary steps should be taken to fully comply with IFAC's seven Statements of Membership Obligation.

73. **Strengthen capacity of ICMAP to function as a premier professional body of management accountants in the region.** In order to augment the training provision for existing and potential corporate accountants, ICMAP's capacity should be strengthened with primary focus on management accounting issues. Since the members of ICMAP, in their capacity as corporate accountants, mainly work on preparation of financial statements, it will be important to equip them with detailed knowledge of the practical application of IFRS. The capacity improvements should focus on up-to-date teaching materials and training of instructors by establishing cooperation arrangement with the Chartered Institute of Management Accountants (CIMA) in the United Kingdom.

74. **Upgrade the procedure for obtaining license by the accountants and auditors engaged in public practice.** The ICAP should streamline its licensing procedure by aligning its professional examination and training arrangements with IFAC education guidelines, such as International Education Guideline (IEG) 9, *Prequalification, Education, Assessment of Professional Competence, and Exposure Requirements of Professional Accountants*; and IEG 10, *Professional Ethics for Accountants*. ICAP should also effectively monitor that registered accounting education tutors and practical training providers provide adequate exposure to the practical aspects of all applicable standards and codes. Furthermore, ICAP should develop a sound mechanism for renewing practice license of the auditors in public practice on the basis of their periodic performance evaluation.

75. **Improve the delivery of the continuing professional education.** The ICAP should organize high-quality training programs/workshops to enable the accountants and practicing auditors to gain exposure to the practical application of IFRS, ISA, and IFAC-issued Code of Ethics for Professional Accountants. To meet requirements of continuing professional education, practitioners should be encouraged to attend such training programs across the country.

76. **Take steps for improving academic and professional curriculum and education.** In adopting IFRS and ISA, Pakistan has set challenging and demanding objectives for itself. This requires a need for ensuring high-quality education and training

on the international standards. Immediate steps should be taken in consideration of the following recommendations:

- Review and update the accounting curricula to incorporate IFRS and ISA at institutions of higher learning. Teaching should focus on the practical implementation aspects of these standards using illustrations and cases. The ethical issues embedded in business management, auditing, corporate finance should be incorporated in the curricula. Furthermore, emphasis should be placed in teaching English and communication skills and developing critical-thinking ability of students.
- Arrange retraining of university and college teachers for improving their knowledge base for teaching IFRS and ISA.
- Review the curriculum for adequate coverage of professional ethics. Business ethics should be taught as a separate subject for the professional accountants.
- Provide IFRS training to tax officials. As IFRS net income is the starting point of the accounting and tax reconciliation, tax personnel should have a sound understanding of IFRS.

77. Develop simplified accounting and reporting requirements for the SMEs. Since IFRS is not appropriate in all circumstances for the SMEs, the standard setters in Pakistan should consider developing simplified SME reporting standards. Lessons may be taken from the region³⁷ as well as from the current work of International Accounting Standards Board (IASB) on the application of IFRS to the SMEs.

78. Rationalize the Companies Ordinance for improving the compliance culture. Take steps to rationalize provisions of the Companies Ordinance with regard to mandatory IFRS application only to public interest entities, requiring the nonlisted companies to file their audited annual financial statements to the Registrar of Companies, clarifying the eligibility criteria of auditors for the private limited companies, providing for putting in place an arrangement for independent oversight for the auditing profession, and granting more authority to the regulators for imposing administrative sanctions.

79. Issue practical application guidance on IFRS and ISA. The ICAP should issue implementation guidance on IFRS and ISA illustrating local cases. Interpretations on IFRS and ISA should be issued in consultation with the International Financial Reporting Committee (IFRC) of IASB and the International Auditing and Assurance Standards Board (IAASB) of IFAC. The ICAP should ensure all interpretations and other guidance should be promptly available to its members.

80. Introduce awareness programs for improving the degree of compliance with IFRS requirements. The ICAP and SECP should work jointly to design awareness programs highlighting the significance of compliance with accounting and auditing standards. Shareholders, directors, and top officials from the corporate sector should be briefed adequately on their responsibilities with regard to their roles in ensuring

³⁷Institute of Chartered Accountants of Sri Lanka (ICASL) has adopted a set of simplified reporting requirements for the SMEs.

compliance with standards and enforcement process, including legal implications. Also, benefits of compliance with standards and best practices should be highlighted in such programs. In addition, these programs should include cases focusing on emerging international developments and the role of transparent financial reporting in attracting both strategic and portfolio investors.

81. Prescribe guidance to ensure adequate ethical standard and independence of auditors. ICAP should consider the following for ensuing ethical standard and independence of practicing auditors in line with international best practices:

- Prohibiting the practicing auditors from preparing the financial statements of their clients.
- Discouraging auditors' involvement in providing both audit services and tax advocacy for the same client.
- Prescribing a "cooling-off" period for partners and senior and other managers of an audit firm before they are allowed to join a company with which they have done audit work. Reciprocally, a similar "cooling-off" provision should be applied to staff of an audit firm's client company before joining that audit firm.

ABBREVIATIONS AND ACRONYMS

ACCA	Association of Chartered Certified Accountants (United Kingdom)
CEO	chief executive officer
CFO	chief financial officer
CAPA	Confederation of Asia Pacific Accountants
CBR	Central Board of Revenue
DFI	development financial institution
FY	fiscal year
GDP	gross domestic product
GNI	gross national income
GoP	Government of Pakistan
IAASB	International Auditing and Assurance Standards Board
IAS	International Accounting Standard
IASB	International Accounting Standards Board
ICAP	Institute of Chartered Accountants of Pakistan
ICMAP	Institute of Cost and Management Accountants of Pakistan
IEG	International Education Guideline
IFAC	International Federation of Accountants
IFRC	International Financial Reporting Committee
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
ISA	International Standard on Auditing
KSE	Karachi Stock Exchange
PKR	Pakistan Rupee
QCR	Quality Control Review
ROSC	Reports on Observance of Standards and Codes
SAFA	South Asia Federation of Accountants
SBP	State Bank of Pakistan
SECP	Securities and Exchange Commission of Pakistan
SME	Small and medium enterprise
SOE	state-owned enterprise