

Report No. 54306-AF

# Afghanistan

## Report on Observance of Standards and Codes (ROSC) – Accounting & Auditing

**February 16, 2009**

Financial Management Unit  
South Asia Region



Document of the World Bank

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## ABBREVIATIONS AND ACRONYMS

<b>ACCA</b>	Association of Chartered Certified Accountants
<b>ADB</b>	Asia Development Bank
<b>AISA</b>	Afghanistan Investment Support Agency
<b>CAT</b>	Certified Accounting Technician
<b>CPE</b>	Continuing professional education
<b>DAB</b>	Da Afghanistan Bank
<b>DFID</b>	Department for International Development
<b>FDI</b>	Foreign Direct Investment
<b>NOFM</b>	Financial Management
<b>FSD</b>	Financial Supervision Department
<b>GAAP</b>	Generally accepted accounting principles
<b>GDP</b>	Gross domestic product
<b>GPFS</b>	General Purpose Financial Statements
<b>IAAA</b>	Institute of Accountants and Auditors of Afghanistan
<b>IAS</b>	International Accounting Standards
<b>IASB</b>	International Accounting Standards Board
<b>IASC</b>	International Accounting Standards Committee
<b>IFAC</b>	International Federation of Accountants
<b>IFC</b>	International Finance Corporation
<b>IFRS</b>	International Financial Reporting Standards
<b>IMF</b>	International Monetary Fund
<b>ISA</b>	International Standards on Auditing
<b>LCSEFM</b>	Latin America and Caribbean Financial Management
<b>OPCFM</b>	Operations and Policy Coordination Financial Management
<b>PCAOB</b>	Public Company Accounting Oversight Board (of USA)
<b>QOB</b>	Quality Oversight Board
<b>ROSC</b>	Report on Observance of Standards and Codes
<b>SOES</b>	State Owned Enterprises
<b>MOF</b>	Ministry of Finance
<b>SAR</b>	South Asia Region
<b>SME</b>	Small and Medium sized entity
<b>USAID</b>	United States Agency for International Development

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**AFGHANISTAN**  
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## ACKNOWLEDGEMENTS

This report was prepared by a task team comprising Paul Sisk, Lead Financial Management Specialist, SARFM, Donna Thompson, Senior Financial Management Specialist, CTRLP Reazul Islam, Senior Private Sector Development Specialist, SASFP, Manoj Jain, Senior Financial Management Specialist, SARFM, Asha Narayan, Financial Management Analyst, SARFM and Kenneth Okpara, Senior Financial Management Specialist, SARFM (Task Leader).

The study was carried out in active collaboration with the Government of Afghanistan (GoA) and the various stakeholders including the Ministry of Finance, Ministry of Commerce and Industry, Da Afghanistan Bank, Afghanistan Investment Support Agency, Control and Audit Office of Afghanistan, Asian Development Bank, US Agency for International Development and UK Department for International Development. The review was conducted through a participatory process that involved these stakeholders and was led by the country authorities. It included facilitated discussion and round table meetings with the representatives of the profession and other stakeholders.

We gratefully acknowledge the valuable and extensive contributions of the stakeholders and representatives of the profession. We also thank the officials and the coordinators in the various institutions for their valuable assistance in facilitating this study.

World Bank staff including, Robert J. Saum (Manager, SARFM), Zubaidur M. Rahman (OPCFM) and Rama V. Krishnan (SARFM) provided valuable inputs and suggestions. The report also benefited immensely from comments of peer reviewers: Ian Mackintosh, Chairman of the UK Accounting Standards Board, Kathleen M. Moktan, Director, CDGDRSD Department of Asian Development Bank and Henri Fortin, Senior FMS, LCSFM, World Bank. Thanks are also due to Naqib Musa and Parwana Nasiri for their efficient administrative support throughout the study.

Various background documents were prepared and completed during the course of this study including the 4-part diagnostic tool that has been developed by the World Bank for this exercise.

## EXECUTIVE SUMMARY

The parliamentary and provincial elections of November 2005 brought the culmination of the political transformation for Afghanistan that had commenced with the Bonn Agreement in 2001, forming the basis for state-building and development in a country emerging from nearly three decades of conflict and political turmoil.

There is progress in many sectors, and in particular, the private sector. The major reason for undertaking this Accounting and Auditing ROSC is to help the Government of Afghanistan (GOA) prepare for private sector growth and for proper handling of governance and other similar issues that may arise as the private sector develops. Also, the reason why it is being done at this point in time, is the interest from development partners in Afghanistan, like the International Finance Corporation (IFC), World Bank Finance sector colleagues, Department of International Development (DFID), Asia Development Bank (ADB) and United States Agency for International Development (USAID) in supporting the Accounting and Auditing profession, with a common understanding that the Report on Observance of Standards and Codes (ROSC)-Accounting & Auditing will be the accepted analytical instrument to provide the background for their desired activities, possible privatization of State Owned Enterprises (SOEs) and the need to have a framework in place for oversight of accounting and auditing. In addition, the ROSC will also provide background for dialogues on accounting and auditing issues to better determine short-term and longer-term initiatives, along with any necessary interim solutions during this continuing period of transition.

The international community is now deeply committed to supporting Afghanistan's reconstruction, after a long history of conflict. In addition, local businesses face a serious lack of access to finance. Though, Foreign Direct Investment (FDI) into Afghanistan has been consistent, it has recently been on the decrease. In order to accelerate this reconstruction, the financial system will need to provide assurance to the providers of capital on the financial position and financial results of local enterprises, not just after they have invested but even in order for them to commit the initial investment. This report aims to lay the foundations for the establishment of a robust, contemporary and deep accountancy profession and regulatory environment in Afghanistan.

Afghanistan has made significant progress over the last few years through rebuilding efforts guided by the international community. There are almost 10,000 entities registered with the corporate registry the Afghanistan Investment Support Agency (AISA) though several maybe dormant or defunct, and the state owned enterprises dominate the corporate sector. Whilst there is a new Law of Corporations and Limited Liability Companies, there is no local accounting or auditing standards, professional regulator, corporate regulator or oversight organization. There are 16 audit firms registered with AISA though it is likely that more than half are inactive, and there are fewer than 20 qualified accountants in the city of Kabul. Statutory audits are not legislated even in the new corporate legislation, other than in Insurance and Banking law, and thus there is limited demand for audit services.

With no approved body representing the profession in the country, students choose the Certified Accounting Technician (CAT) qualification of Association of Chartered Certified Accountants (ACCA) as it is the only available professional qualification in the country, and one that does not mandate any practical training.

There is no corporate regulator in Afghanistan, and whilst there is an Insurance regulator, there are no insurance companies currently in operation. Da Afghanistan Bank (DAB) is the Banking regulator and has a relatively proactive offsite and onsite supervision process.

Financial statements, which are expected to be prepared in accordance with international standards (IFRS/ IAS), are usually incomplete, if at all available. In the absence of national standards, audit firms are often expected to follow International Standards on Auditing, as set by local legislation, business practice or international network requirements. SOE financial statements are not required to be audited. The quality of financial statements and compliance with auditing standards are poor, though there are a few exceptions, particularly in the banking sector.

Given the above scenario, a government led National Steering Committee (NSC) should be established to coordinate, supervise and direct the significant financial reporting and auditing reforms that will be required in Afghanistan. This Committee should serve as the ultimate trustees of ensuring that Afghanistan has a high quality financial reporting and auditing system in place.

The NSC would develop an action plan (including short, medium and long term measures) to develop accounting and auditing capacity in Afghanistan. This action plan would form the basis for a government program of education and training, which would likely require both financial and technical support from development agencies. Large scale education and training in Accounting and Auditing has to be at the backbone of the establishment of the profession in Afghanistan, if the effort is to be successful and the profession is to meet its objectives. Unless there are high quality accountants coming out of the education system locally, setting up an Institute Regulatory oversight body or financial reporting legislation will have little relevance. The choice of language (English/Dari) for education and training will need to be in line with the national consensus on the matter, though in a world where accounting, auditing, regulatory standards are converging towards one common standard, the costs, practicality and challenges of adopting Dari would need to be recognized and factored into determining the way forward.

It is important that the Government closely supervise the creation of the accountancy profession, and hands over functions to the professional institute only when it has adequate capacity to be able to sustain itself. At the same time, in line with best practice, it is also important that provisions and institutions are in place whereby at an appropriate time in the future oversight of the profession and is not left entirely in the hands of the profession.

A sequenced and prioritized action plan, within the overall development framework of Afghanistan put in place by the National Steering Committee, with clear assignment of responsibility and identification of required resources, will lay down the roadmap to take forward and implement work already done under previous donor projects towards establishing an accountancy institute and the Institute of Accountants and Auditors of Afghanistan (IAAA) and AAB, and the other recommendations in this report.

## **I. INTRODUCTION AND BACKGROUND**

1. This report is based on a review of the strengths and weaknesses of corporate accounting and auditing practices in Afghanistan. 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), which covers a set of twelve internationally recognized core standards and codes relevant to economic stability and private and financial sector development<sup>1</sup>. The review involved the assessment of actual

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<sup>1</sup> Within the ROSC initiative, the World Bank and the IMF assist member countries in implementing international standards and codes; the first step in this regard is to carry out assessments and prepare reports in a modular form in each of the following areas: 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 financial policy transparency, payments systems, and securities regulation.

practices and an analysis of the effectiveness of monitoring and enforcement mechanisms, in the area of corporate accounting and auditing in Afghanistan. International Financial Reporting Standards (IFRS)<sup>2</sup> and International Standards on Auditing (ISA) served as benchmarks for evaluating comparability of locally applicable accounting and auditing requirements. The review used a diagnostic template developed by the World Bank to facilitate collection of information. The information was complemented by the findings of a due diligence exercise, based on a series of meetings with key stakeholders, conducted by World Bank staff and consultants.

2. Following five years of rebuilding efforts, the Afghanistan economy has made significant progress with strong real compound growth rate of 60%, and with GDP growth averaging more than 17 percent per annum. The surge in growth rate, albeit from a very depressed base, is mainly due to continued donor support and a boom in construction in urban cities. The economy is expected to continue to achieve high growth rates during the next few years. Per capita income is expected to increase to US\$ 294 per annum, representing an increase of 2.4 times than that of 2001-02 when the per capita income was barely US\$ 123 per annum. However, the real GDP and per capita income does not include the informal GDP generated through the drug economy which is estimated to be one- third of the real GDP; inclusion of this illegal economy is expected to push the per capita income up to about US\$400 per annum.

3. The foreign direct investment (FDI) in Afghanistan has remained consistent in recent years. In terms of absolute numbers, FDI has increased from US\$ 49 million to US\$ 250 million during 2003-04 to 2005-06, but during 2006-07 it was US\$ 216 million. However, this FDI is largely concentrated in the infrastructure (construction and telecom) sectors and there has been a lack of interest from foreign investors to invest in other sectors of the economy due to the current business environment, security situation and other constraints, including the lack of local financial and regulatory institutions.

4. **The contributions of the international community to implement reforms and to develop infrastructure is significant, with more than US\$ 8.9 billion committed to date.** This is over and above the contributions received from multilateral development institutions, which are being used to fund significant construction projects, such as state buildings, roads, bridges, and public institutions like schools and hospitals.

5. **Afghanistan is faced with five key constraints, which are hindering domestic and foreign investment in the country:** (a) shortage of electricity, (b) difficult access to land with clear title, (c) excessive corruption, (d) lack of access to finance and e) security. Despite a recent resurgence, the Afghanistan economy still remains agrarian, mostly consisting of small farms. Outside of agriculture, the private sector is dominated by informal family owned micro enterprises, most of which are engaged in trading or other basic services. There are a few small and medium enterprises (SMEs) and only a handful of large firms. The largest companies are among the existing state owned enterprises (SOEs) which include financial institutions as well as manufacturing and service firms. The manufacturing sector is small and production is highly concentrated in a few industries.

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<sup>2</sup> Within this report, 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). IASC-issued standards are known as International Accounting Standards (IAS) and IASB-issued standards are known as International Financial Reporting Standards (IFRS). In line with IASB's pronouncements, it is a common practice to refer to IFRS meaning both IFRS and IAS. However, in the policy recommendations section of this report, "IAS/IFRS" has been used to mean all standards and related interpretations issued by IASB and IASC.

## II. INSTITUTIONAL FRAMEWORK

### A. STATUTORY FRAMEWORK

6. **The troubled and turbulent history of Afghanistan has led to the lack of a modern unified legal system.** Prior to 1922, the political structure was limited to the councils of tribal leaders where the religious scholars provided legitimization for the new concept and constructing from Quranic passages. The reform movements of early 20<sup>th</sup> century gave rise to several unsuccessful efforts to secularize or westernize the Afghan legal system. Since then the law in Afghanistan has developed into a disunified amalgamation of secular legislation, Shari'a, and local custom, variously applied according to local practice and adherence to government authority. The Islamic law of the Hanafi School of jurisprudence however remains the law that is thought to substantially prevail. A number of different constitutions have been issued by various regimes over a relatively short period of time<sup>3</sup>. Although Islamic law is the constant that has survived throughout the many upheavals in Afghanistan, the common belief is that Shari'a will continue to play a major role as a primary source of Afghan law. As the new Afghan government continues to develop, it is clear that new laws, if not an entirely new legal structure, will eventually come into being.

7. **At present, more than 450 acts, decrees, and directives contain provisions and guidelines for the primary functioning of the Government of Afghanistan.** In July 2005, 125 laws have been promoted or drafted by the Government with support of international organizations<sup>4</sup>, although only a few of these draft laws have been enacted<sup>5</sup>. Through a legislative action plan that calls for the finalization of certain commercial laws, three new laws were approved on January 30, 2007, that yet to be approved by Parliament<sup>6</sup>:

- i. Corporations & Limited Liability Companies Law
- ii. Partnership Law
- iii. Arbitration Law and Mediation Law.

Apart from these, three other important laws relevant to A&A are at the draft stage:

- i. Secured Transactions of Moveable Property Law
- ii. Secured Transactions of Immovable Property Law
- iii. Negotiable Instruments Law.

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<sup>3</sup> The first Afghan constitution was promulgated in 1923, followed by one in 1931. In 1964 the first nominally liberal constitution was issued, emphasizing the secularization of Afghan Law. Following the coup of 1973, a series of "Republic decrees" served as the constitution until the promulgation of a western- style constitution in 1977. One year later, another coup resulted in the abrogation of the 1977 constitution and issuance of a new set of decrees of the revolutionary Council of the Democratic Republic of 1978. Three more decrees were then issued, which resulted in a body of "constitutional laws" of 1979. A provisional constitution, the basic principle of the Democratic Republic of Afghanistan was promulgated in 1980. A new constitution was enacted in 1987 and further amendments to it approved in 1990, but it is unknown whether this constitution was ever officially promulgated.

<sup>4</sup> The Ministry of Justice is charged with the duty of drafting and reviewing legislation on behalf of the line ministries and other agencies and also is responsible for passing drafts for eventual presentation to the National Assembly for its consideration.

<sup>5</sup> A law progress chart can be reviewed at [www.commerce.gov.af](http://www.commerce.gov.af).

<sup>6</sup> The bodies that were involved in the drafting and reviewing new laws, include the Afghan Investment Support Agency (AISA), Ministry of Foreign Affairs (MoFA), Ministry of Finance (MoF), Ministry of Commerce (MoC), Ministry of Justice (MoJ), Judicial Reform Commission (JRC), Afghan Economic Governance Project (USAID) (AEGP), Da Afghanistan Bank (DAB), American Bar Association/Center for International Management Education (ABA/CIME), Afghan Governance and Legal Reform Project (USAID) (AGLR).



8. **Due to the lack of institutional capacity and limited resources the Ministry of Justice cannot realistically meet the demands placed upon it.** There is a lack of coordination and communication among Government agencies which have been entrusted with preparing draft laws. Furthermore, there is uncertainty as to the status of the current laws in Afghanistan. There is a severe lack of translation capacity from the official languages of Dari and Pashto into English. To fill this gap, USAID, the United Nations, and other organizations have funded publication of existing laws for nationwide dissemination and have produced a single DVD-ROM compilation containing complete digital image scans of all known existing issues of the Official Gazette from 1964 until date. International experts are carrying out a variety of activities intended to improve legislative drafting capacity, such as training on drafting techniques and advising on specific laws during the drafting stage.

9. **The most recent Private Investment Law was enacted in 2005,** pursuant to Article Ten of the Constitution of Afghanistan, to promote the role of private investment, both domestic and foreign, and to create a legal regime together with an administrative structure that will encourage, support and protect investors. A High Commission on Investment<sup>7</sup> was formed in 2003 under private investment law, and is regarded as the highest government authority for developing investment policies and to perform related administrative duties.

10. **The premier investment agency the AISA was formed under the Private Investment Law.** AISA has responsibility to facilitate registration, licensing and promotion of all investments in Afghanistan. It concentrates on measures to attract industrial investment from both within and outside Afghanistan.

11. **The legislative and regulatory regimes of Afghanistan that deal with issues of commercial entities do not have the capacity to support the requirements of the modern commercial world** including access to credit and existence of suitable debt and equity markets. Important existing legislation which impact commercial entities include:

- i. Commercial Code of 1955
- ii. Banking Law of Afghanistan of 1976, with amendments in 1977 and 2003
- iii. Da Afghanistan Bank Law of 2003
- iv. Insurance law of 1989, with amendments of 2005
- v. Law of State Owned Enterprises of 1991, with amendments of 2005.

Two newly approved commercial entity legislations which impact commercial entities are:

- i. Corporations & Limited Liability Companies Law of 2007, and
- ii. Partnership Law of 2007

12. **There is no code of corporate governance currently prescribed, except for the banking sector.** The Commercial Code Law of State Owned Enterprises, Insurance Law and the recently enacted Law of Limited Liability Companies and Corporations do not contain any legislative provision in this regard. However for banks, a code of corporate governance is prescribed under the by-laws (prudential regulations) of DAB.

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<sup>7</sup> The Commission is composed of: i) Minister of Commerce, ii) Minister of Finance, iii) Minister of Foreign Affairs, iv) Minister of Economy, v) Minister of Mines and Industries, vi) Minister of Agriculture, Animal Husbandry and Food, vii) Governor of The Central Bank of Afghanistan and viii) Chief Executive Officer of AISA .

13. **AISA is the sole government agency charged with responsibility for registration, licensing and promotion of all new investments in Afghanistan.** A total of 9,843 approved entities are registered with AISA, consisting of limited liability companies (86%), sole proprietorships (8%), partnerships (4%), and corporations (2%):

Entity Type	Registered entities		Registered Employees		Registered capital	
	No.	%	No.	%	million US\$	%
<b>Corporation</b>	152	<b>2%</b>	16,267	<b>5%</b>	363.74	<b>11%</b>
<b>Limited liability</b>	8,433	<b>86%</b>	306,821	<b>86%</b>	2,754.13	<b>82%</b>
<b>Partnerships</b>	440	<b>4%</b>	10,400	<b>3%</b>	69.59	<b>2%</b>
<b>Sole proprietors</b>	818	<b>8%</b>	22,546	<b>6%</b>	190.08	<b>6%</b>
<b>Total</b>	<b>9,843</b>	<b>100%</b>	<b>356,034</b>	<b>100%</b>	<b>3,378</b>	<b>100%</b>
<b>Sector</b>						
<b>Services</b>	1,691	<b>17%</b>	62,642	<b>18%</b>	971.68	<b>29%</b>
<b>Construction</b>	5,491	<b>56%</b>	199,209	<b>56%</b>	1,144.12	<b>34%</b>
<b>Industry</b>	2,463	<b>25%</b>	88,874	<b>25%</b>	1,060.80	<b>31%</b>
<b>Agriculture</b>	198	<b>2%</b>	5,309	<b>1%</b>	200.94	<b>6%</b>
<b>Total</b>	<b>9,843</b>	<b>100%</b>	<b>356,034</b>	<b>100%</b>	<b>3,378</b>	<b>100%</b>

Source: April 2008, obtained from AISA

14. **Registration with AISA is now mandatory for all private sector enterprises, except trading companies that must register with the Ministry of Commerce, and small retail businesses that must registered with Municipalities.** Registration with AISA defines the entity's legal status, and helps to obtain a tax number from the Ministry of Finance. Enterprises with initial capital of US\$ 3 million and above also need approval of the High Commission on Investment, before they can be registered with AISA. Similarly certain businesses (for-example telecom, banking and media companies) require an additional "Operational License" from the relevant ministries.

15. **Afghanistan has an old banking sector that concentrates on the private sector.** Bank Millie, Afghanistan's first private bank, was established in 1933. Today there is virtually no lending to local enterprises, and banking is primarily limited to deposit-taking. The US dollar is the primary currency in Afghanistan's cash-only economy. Although DAB has licensed 15 commercial banks, most are concentrated in Kabul and provide services primarily to international donors, foreign NGOs and foreign government agencies. The banks have not yet started lending to industry and do not seem to be inclined to do so in the near future. A strong accountancy profession, increase in the availability of qualified accountants and a more adequate regulatory environment should facilitate a change in bank lending policies.

16. **There are about 65 SOEs, a majority of which are likely to be privatised in the near future.** These SOEs are under the direct supervision of the relevant ministry with their financial affairs supervised by MOF. SOE financial reporting is usually in Dari, and consists of a basic set of financial information supports similar to a trial balance, as opposed to general purpose financial statements. Availability of high quality audited financial statements, ideally prepared and audited in accordance with standards that are understood by the global community, will assist in facilitating the privatisation process.

17. **The business registration process is fairly simple and investor friendly and generally takes about one week's time.** AISA conducts a verification process as part of the business registration in which it verifies the investor's identity and business plans. The registration process requires the investor to fill out a standard 'company statute', a document similar to an 'Articles of Association'. The investor can choose any one of the four available legal forms of incorporation i.e. i) sole proprietorship, ii) partnership, iii) corporation and iv) limited liability company. AISA arranges for the publication of a 'public information summary' in one of the national newspapers and the official government Gazette. With AISA business registration, the approved entities obtain tax concession, customs relief, access to banking, right to employ expatriate staff, right to lease immovable property<sup>8</sup> and free repatriation or transfer of loans, capital and profits associated with foreign investment.

18. **The database<sup>9</sup> of details of companies registered with AISA is comprehensive, but far from complete, accurate or up-to-date.** Changes in the ownership or capital structure are tracked through the annual returns that must be filled by all registered entities within 90 days of the end of the fiscal year. Using the AISA database, we tried to contact a sample of entities to obtain their audited financial statements, but we were unable to reach most of the selected entities, implying that the information in the database is outdated. We understand that a peculiar business practice in Afghanistan is to register an existing business with a new name with AISA regularly as a means of avoiding income tax assessments. Companies, especially small ones do not regularly file their AISA Annual Returns.

19. **Normally the corporate sector regulator derives its mandate from the relevant corporate law of the country, however in the case of AISA, the mandate is given under the Law of Private Investment.** As such AISA is not effectively a corporate regulator as it is not responsible for monitoring the corporate sector compliance with the Commercial Code of 1955 or with the Law of Limited Liability Companies and Corporations.

20. **The following matrix provides a summary of financial reporting requirements for the five different types of commercial entities permitted in Afghanistan:**

	COMMERCIAL CODE (OF 1955)	*LAW OF CORPORATIONS & LIMITED LIABILITIES COMPANIES (2007)	LAW OF STATE OWNED ENTERPRISES of 1991 (amended in 2005)	Banking Law of 1976, (amended in 1977 & 2003)	Insurance Law of 1989, (amended in 2005)
<b>Financial Statements</b>					
<b>a) Balance sheet</b>	Yes	Yes	Yes	Yes	Yes
<b>b) Income statement</b>	Not mentioned	Yes	Not mentioned	Yes	Not Mentioned
<b>c) Legal Entity Financial Statements</b>	Not mentioned	Yes	Yes	Yes	Not Mentioned
<b>d) Group Financial Statements</b>	Not mentioned	Not mentioned	Not mentioned	Yes	Not Mentioned
<b>Standards to be applied</b>	Not mentioned	No specific format of the Financial Statements, however law prescribe adherence to International Accounting standards	Accounting affairs shall be carried out in accordance with the standard accounting plan and accounting forms approved by MOF.	Yes	Not Mentioned
<b>Publication requirements</b>	Not mentioned	Not mentioned	Not mentioned	Yes	Not Mentioned

<sup>8</sup> For a period of up to 50 years.

<sup>9</sup> This database contains particulars including addresses, telephone mobile and e-mail numbers of the investors.

	COMMERCIAL CODE (OF 1955)	* LAW OF CORPORATIONS & LIMITED LIABILITIES COMPANIES (2007)	LAW OF STATE OWNED ENTERPRISES of 1991 (amended in 2005)	Banking Law of 1976, (amended in 1977 & 2003)	Insurance Law of 1989, (amended in 2005)
<b>Filing requirements</b>	The law prescribes the procedure for marking and sealing of the books of accounts from the local registration office	Financial statements and books have to be made available to the shareholders	The law requires filing of the progress report to the relevant ministry.	Banks need to provide annual audited financial statements to DAB, shareholders and public.	Filing of annual balance sheet to the ministry of finance
<b>Deadlines for publication</b>	Not mentioned	Not mentioned	Not mentioned	Within 3 months of financial year end	Not Mentioned
<b>Deadlines for filing</b>	Not mentioned	At least 15 days before Annual General Meeting	Quarterly	Within 3 months of financial year end	Before end of the first six months of the following year

*\* Under the Law of Corporations and LLC, enacted in 2007, all relevant legal provisions concerning corporations and limited liability companies in the commercial code of Afghanistan, published in Official Gazette # 89, of 1336 [1957] and the civil code dated 15, 10 1355 [1976] and any other legal provisions which are contrary to the provisions of this law will be superseded.*

21. **The financial reporting requirements under the Commercial Code of 1955 are outdated** as the law only specifies the type of books to be maintained, contents and method of getting the books marked and sealed by the local registration office. The law does not refer to any financial reporting standards or any prescribed financial reporting format.

22. **The provisions of the recently published (applicable but not yet enacted by Parliament) Law of Corporations and Limited Liability Companies (2007) override the provisions of the Commercial Code of 1955, in so far as they relate to corporations and limited liability companies.** This new law requires companies to deliver to their shareholders at least 15 days before the annual general meeting, financial statements<sup>10</sup> duly compliant with the accounting standards set forth by the International Accounting Standards Board. The financial statements, as well as the books and records, are open to all shareholders for investigation.

23. **The Banking Laws of Afghanistan are more stringent, elaborate and extensive than the corporate laws and as such most of the accounting and financial reporting requirements for the banks originate from the banking laws.** However, as banks in Afghanistan operate as Limited Liability Companies, they are also subject to the Law of Corporations and Limited Liability Companies (2007). Under the Banking Law, adherence to international accounting standards is mandatory. The banks have to make their annual audited financial statements available to the Central Bank, their shareholders and to the public within three months after the end of their financial year which must coincide with the calendar year. In case of banks with subsidiaries, the parent company financial statements as well as consolidated financial statements must be presented. Banks also are required to provide to the Central Bank periodic reporting covering monetary statistics, income and expenditure reports, non-performing loans and loan losses, status of provisioning, foreign-currency positions, interest rates, and any other reports of activities as the DAB may request. . Formats of balance sheet and income statements also are recommended by DAB. The current laws that regulate the banking sector in Afghanistan include:

- i. Law of Banking in Afghanistan of 2004
- ii. Law of Da Afghanistan Bank of 2004

<sup>10</sup> Including balance sheet and profit and loss account

- iii. Law on Campaign against Financing Terrorism of 2004
- iv. Law on Campaign against Money Laundering and Income from Crime of 2004
- v. Law of Industrial Banks in Afghanistan of 1971.

The first two laws contain a number of by-laws that prescribe prudential regulations for the banks. Regulations due for enactment in the near future that will impact the banking sector include the Law of Secure Transactions of Movable and Immovable Properties and the Law of Negotiable Instruments.

24. **Under the Insurance law of 1989 (amended 2005), insurance companies are required to submit a copy of their annual balance sheet to the Ministry of Finance before the end of the first six months of the following year.** There are no further details as to the format and content of the financial reporting enumerated in this Insurance Law but the law stipulates that all those situations where this law is silent are to be dealt and settled in accordance with the provisions contained in Commercial code of 1955. The regulatory body for the insurance sector is the Afghanistan Insurance Commission that serves under the Ministry of Finance. Since the sector is not functional at the moment (with only two companies at the licensing stage) further details of the operation of this Commission are not known.

25. **The financial reporting requirements for SOEs are prescribed under the Law of State Owned Enterprises.** Accounting for SOEs needs to be carried out in compliance with the standard accounting plan and accounting forms approved by the Ministry of Finance. A progress report on production and financial activities and annual balance sheet are required to be forwarded to the relevant ministry, Ministry of Finance and to the bank which maintains transactions with the SOE. The financial year of SOEs corresponds to the Solar year. The analysis and evaluation of the economic and financial activities of SOEs are required to be carried out by the specialized branches of the relevant ministry and there is no provision for an independent audit.

26. **The external audit requirements applicable to commercial entities** are contained in the following laws:

- i. Commercial Code of 1955
- ii. Law of Limited Companies and Corporations of 2007
- iii. Banking Law of Afghanistan of 1976 (amended in 1977 and 2003)
- iv. Insurance Law of 1989 (amended in 2005)
- v. Law of State Owned Enterprises of 1991 (amended in 2005)

The following grid explains the mechanisms governing statutory auditor appointment and termination set out in the five commercial entity laws:

	<b>Commercial Code</b>	<b>* Law of Corporations and LLC</b>	<b>Banking Law</b>	<b>Insurance Law</b>	<b>Law of SOEs</b>
<b>Auditor/Board of Supervisors (BOS) is nominated by:</b>	<i>General Assembly (no distinction between nomination and appointment).</i>	<i>Shareholders at the Annual Meeting of Shareholders.</i>	<i>Shareholders at the Annual Meeting of Shareholders</i>	<i>General Assembly (no distinction between nomination and appointment).</i>	<i>Evaluation &amp; supervision is the sole domain of the relevant ministry or agency and there is no specific provision for the appointment of an independent external auditor.</i>
<b>Auditor/BOS is appointed by:</b>					
<b>Auditor/BOS is appointed for a period of:</b>	<i>The first term is for one year, and thereafter for a maximum period of three years</i>	<i>The first term is for one year, and thereafter for a maximum period of three years</i>	<i>Period not mentioned, however approval from DAB is required every year</i>	<i>The first term is for one year, and thereafter for a maximum period of three years</i>	

	Commercial Code	* Law of Corporations and LLC	Banking Law	Insurance Law	Law of SOEs
Requirement for joint audit	There is no specific provision in respect of joint audit				
Requirement for rotation of auditor	There is no provision for the rotation of auditors however under the Law of Corporations and LLC by prescribing a maximum period of 3 years like the other previously enacted laws, rotation is automatically ensured.				

*\* Under the Law of Corporations and LLC, enacted recently in 2007, all relevant legal provisions concerning corporations and limited liability companies in the commercial code of Afghanistan, published in Official Gazette # 89, of 1336 [1957] and the civil code dated 15, 10 1355 [1976] and any other legal provisions which are contrary to the provisions of this law will be superseded (Note: this law is yet to be approved by Parliament).*

27. **In the Commercial Code of 1955 there is no provision regarding the appointment of an external auditor.** The auditing and investigative function is assigned to the Board of Supervisors (BOS) consisting of two persons, appointed by the Board of Directors in the general meeting for a period of three years. The members of the BOS can be elected from amongst the shareholders or from outside, and to avoid any conflict of interest they are prohibited from acting as the directors or taking part in the transactions of the company. A company can have more than one Board of Supervisors. Related parties cannot be appointed as supervisors and their appointment is subject to notifying the commercial registration office. Casual vacancies in the office of the BOS can be filled in by the Board for the remaining term. The Code also prescribes the duties of the BOS, which include the submission of audited financial statements to the general assembly of the company. The code does not specify any kind of professional qualifications for a person to act as a supervisor.

28. **The Law of Corporations and Limited Liabilities Companies of 2007 has borrowed the outdated requirements relating to external audit from the Commercial Code (appointment of two people as BOS) and prescribed exactly the same requirements, basis of selection and related rules.**

29. **Under the Law of State Owned Enterprises (SOEs) accounting and financial reporting is delegated to specialized branches of the relevant ministry or agency.** The Ministry of Finance provides the procedural guidance with regard to planning, financial evaluation, fiscal matters, and reporting affairs of the SOE. Audit is carried out once a year by staff assigned by the ministry and is to be completed within a minimum of 15 days and a maximum of 3 months from the financial year end. Under the Law of SOEs there is no specific provision for appointment of an independent auditor.

30. **Under the Insurance Law, the accounting activities of insurance companies are required to be audited and verified annually by internal or external authorised auditors.** The law does not prescribe appointment, termination and retirement procedures for such auditors. However, wherever the Insurance Law is silent, provisions contained in the Commercial Code of 1955 are supposed to prevail.

31. **Contrary to the other commercial entity legislations that prescribe the position of BOS as the auditor with no specific requirement for an independent external audit, the Banking Law has clear provisions regarding the appointment of independent external auditor and lays down detailed eligibility criteria for this purpose.** The Banking Law requires that each domestic bank and each non-resident bank appoint an independent external auditor with qualifications and experience acceptable to DAB. For this purpose, DAB's approval is to be sought every year. Recently a detailed directive named 'DAB External Audit Approval Process Policy' (addressing Basel Core Principle # 17) was issued under the DAB Law that contains detailed provisions, conditions and considerations for the



appointment of external auditor<sup>11</sup>. The contents of this policy document include independence of auditors, qualifications and membership requirements, auditor appointment and termination, scope of work for external audit, audit report format, internal procedures for the use of audit reports by DAB and expected contents of a management representation letter. The appointment of auditors is effected by the general meeting of shareholders/members for one year. With some modifications, this policy could form the basis of auditor appointment across all commercial entities in Afghanistan.

## B. ACCOUNTING & AUDITING PROFESSION

32. **There is a very limited accounting and audit profession in Afghanistan, due to an acute shortage of qualified professionals. There is no recognised body that represents the profession in Afghanistan.** The number of resident foreign qualified Certified or Chartered Accountants is estimated at less than twenty in Kabul, a city of four million people and the capital of Afghanistan. International consultants and expat accountants are hired at premium rates and are being used in various accounting, audit, advisory and consulting roles. This comes at very high cost not only in monetary terms but also in terms of missed opportunities to build sustainable local capacity. The only professional accountancy body in Afghanistan is the Afghan Chapter of the Association of Chartered Certified Accountants (ACCA). Due to the poor educational standards, Afghan students are opting for the CAT qualification of ACCA – a qualification that does not require formal prior education history. Auditors are not subject to civil liability under any legislation and there is no law that provides for auditors to obtain professional indemnity insurance.

33. **There are 16 approved accounting and auditing firms that are registered with the AISA.** Many audit firms have limited liability status through their registration with AISA as limited liability companies. Most of these firms are branch offices of South Asian accounting and auditing firms<sup>12</sup> with sizes varying from one man operations to relatively more sizeable offices of some of the larger international accounting networks. Foreign firms with no permanent establishment in Afghanistan are also permitted to audit local entities. It is not uncommon for unqualified accountants to be partners in an audit firm, especially in small firms. With no audit law or regulator to govern the accounting and audit profession, firms are not subject to any code of ethics.

34. **The local branches of large international accounting firm networks dominate the limited audit market in Afghanistan,** including auditing almost all the banks operating in the country. Most of

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<sup>11</sup> Under the proposed ‘Law on Accounting and Auditing’ compliance with International Standards on Auditing (ISA) is mandatory under article 11 which requires the auditor to express an opinion on the financial statements by applying ISA. The following are the salient features of the new draft audit law:

- i) specifies the eligibility criteria for auditors and MOF is to prescribe conditions for licensing of auditors
- ii) establishes the Institute of Accountants and Auditors of Afghanistan (IAAA) as a self-regulating, independent professional organization under the coordination of MOF
- iii) a mechanism for preparatory actions and recommends the constitution of a transitional Board comprising 12 members to be selected from accounting profession, chambers of commerce, Banking Institute of Afghanistan, DAB, MOF and University of Kabul. The transitional governing Board is supposed to be temporary and be responsible for preparing constitution, by-laws, code of ethics etc.
- iv) The permanent governing Board of the Institute is mandated to comprise 11-15 Board members elected from the Institute, DAB, chambers of commerce, MOF and the economic faculty of Kabul University
- v) Licenses issued to auditors to be renewed every two years upon proof of meeting education requirements (CPE) and other conditions imposed by the Institute. The Institute is expected to be financed from annual membership fees and other sources.
- vi) The Institute is also authorised to issue licenses to foreign accountants and auditors who have been licensed under their national regulations.

<sup>12</sup> Indian, Pakistani and Bangladeshi firms

these firms have presence only in Kabul and it is likely that with the improving security and law and order situation in the country, these firms will expand their networks to other cities soon.

35. **An international donor project<sup>13</sup> has recommended establishing an Institute of Accountants and Auditors of Afghanistan (IAAA) to function as a self-regulated independent professional body.** The concept of a Government controlled Accounting and Auditing Board to regulate the accounting profession is also under consideration<sup>14</sup> among donors and the MOF. Given the Afghanistan context, a post conflict country with weak professional capacity and institutions, the Government and all stakeholders would need to agree on a balance between these two proposed bodies.

36. **A new law on Accounting and Auditing has been proposed and developed through a donor sponsored project<sup>15</sup> and has provisions for maintaining books of account, preparation of financial statements, and the manner of performing audits of financial statements.** It also requires financial statements to be prepared in compliance with IFRS and audits to be conducted in accordance with ISA. Large entities are required to employ the accrual basis of accounting, while SME entities have the option to adopt the cash basis of accounting. The draft law lays down eligibility criteria for auditors and entrusts licensing of auditors<sup>16</sup> to the MOF.

37. **The IAAA is proposed to be established as a self-regulating, independent professional organization under the coordination of MOF, being run by a Governing Board comprising of 11-15 members<sup>17</sup>.** The draft law provides for the constitution of a Transitional Governing Board comprising 12 members<sup>18</sup> to serve as a temporary bridge until the IAAA is formed and to do the base work to enable smooth set up and functioning of the Institute e.g. preparing the constitution, by-laws, code of ethics, etc. The IAAA is expected to be financed mainly from annual membership fees. The draft law specifies certain international accounting standards to start convergence with global standards IAS 1 to IAS 18<sup>19</sup>. The IAAA is to be allowed to issue licenses to foreign accountants licensed under their national regulations, provided the IAAA deems such national regulations to be in line with Afghan regulations.

### C. PROFESSIONAL EDUCATION AND TRAINING

38. **There is no evident effort by the Government of Afghanistan (GOA) to introduce accounting and finance courses at university level.** The curriculum followed in the University of Kabul does not extend to teaching IFRS or ISA. Amongst the few key institutions imparting professional

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<sup>13</sup> USAID project “Capacity Development Project – Private Sector Accounting Reform” in collaboration with Ministry of Finance

<sup>14</sup> This concept was originally proposed by the Afghanistan Government, and now is supported by ADB.

<sup>15</sup> Capacity Development Project of ADB and sponsored by the Ministry of Finance

<sup>16</sup> Licenses issued to auditors are to be renewed every two years upon proof of meeting continuing professional education (CPE) requirements and other conditions imposed by the IAAA

<sup>17</sup> Elected from the Institute by Central Bank, Chamber of Commerce, Ministry of Finance and Economic Faculty of the University of Kabul

<sup>18</sup> These members will be selected from the accounting professionals, Chambers of Commerce, Banking Institute of Afghanistan, DAB, MOF and University of Kabul.

<sup>19</sup> This includes IAS 1 Presentation of Financial Statements; IAS 2 Inventories; IAS 3 Cash Flow Statements; IAS 4 Net Profit or Loss for the Period, Fundamental Errors & Changes in Accounting Policies; IAS 5 Contingencies and Events Occurring After the Balance Sheet Date; IAS 6 Construction Contracts; IAS 7 Income Taxes; IAS 8- Information Reflecting the Effects of Changing Prices; IAS 9- Property, Plant, and Equipment; IAS 10 Leases; IAS 11 Revenue; IAS 12 Borrowing costs; IAS 13 Accounting for Investments; IAS 14 Related Business Organizations; IAS 15 Accounting for Investments in Related Business Organizations; IAS 16 Disclosures in the Financial Statements of Banks and Other Financial Institutions; IAS 17 Financial Reporting of Interests in Joint Ventures; IAS 18 Intangible assets.



accounting education, the Afghan International University offers courses for CAT<sup>20</sup> and ACCA professional examinations, both administered and certified by the ACCA of the United Kingdom. The University is also engaged in providing accounting training to more than 400 Government employees. Prior to obtaining full membership of the ACCA, and CAT students are required to obtain three years and one year of practical training respectively. Similarly after attaining the professional membership, there are requirements for continuing professional education. Due to the current political, economic and professional situation, an acute shortage of professional firms, qualified accountants and well regulated business entities, students face various obstacles in obtaining effective training and education to enable them to achieve full membership of a professional accountancy body.

#### D. SETTING ACCOUNTING AND AUDITING STANDARDS

39. **There is no established standard setting body for accounting or auditing, as such there are no enforceable accounting or auditing standards for the private sector.**

#### E. ENSURING COMPLIANCE WITH ACCOUNTING AND AUDITING STANDARDS

40. With no national standards or adopted international standards, this assessment only takes into account the provisions of commercial entity legislation regarding the monitoring provisions related to compliance with accounting, reporting, and auditing requirements.

41. **The Afghanistan Insurance Commission serves under the MOF as the insurance regulator; since the sector is not operational at the moment, with only two companies at the licensing stage, details of supervision and monitoring activities proposed are not known.** It should be noted that insurance companies as limited liability entities, are also subject to the Commercial Code of 1955 and the Law of Limited Liability Companies and Corporations. For SOEs, the monitoring and enforcement of financial reporting functions are assigned to the relevant ministry or agency with no central office/department designated for this purpose.

42. **The Financial Supervision Department (FSD) of DAB is responsible for monitoring compliance with the accounting, financial reporting, and statutory audit requirements in the financial sector (banking and non-banking sub-sectors). The department focuses on monitoring compliance with prudential norms with little focus on monitoring compliance for general purpose financial reporting<sup>21</sup>.** This Department was established in 2003 and has a total of 36 employees out of which 21 are dedicated to conducting on and off sight supervision<sup>22</sup>, with the remaining 15 are administrative staff. The staff members are generally business graduates from different local and foreign universities.

43. **A detailed directive named ‘DAB External Audit Approval Process Policy’ (addressing Basel Core Principle 17) has been issued under the Banking Law that takes into account the conditions and considerations for appointment of an external auditor.** Each year DAB approval must be sought for the appointment of external auditors for each bank in Afghanistan. Although the policy is intended to control the quality of audit firms appointed by banks, there is no monitoring or enforcement of accounting and auditing standards by DAB.

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<sup>20</sup> There are also two other private institutions providing professional education for CAT.

<sup>21</sup> DAB regularly receive just a financial reporting package from Banks instead of IFRS compliant audited financial statements, but has rarely followed up to ask for such statements.

<sup>22</sup> Using a “CAMEL” rating system.

### III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

44. **There are no national or other adopted accounting standards in Afghanistan (though the Law of Corporation and LLC of 2007 prescribes international accounting standards).** Therefore, for the purpose of assessment of the gap between accounting standards as written and as followed, this study has International Financial Reporting Standards (IFRS) were the national standards. Financial statements of seventeen entities from different sectors, including commercial entities, banks, not-for-profit institutions and SOEs were received and varying degrees of compliance with IFRS were found. Rarely did financial statements appear to be compliant in all respects, and most failed to comply with IFRS in matters relating to presentation and disclosure (including disclosure of accounting policies).

45. **The financial statements of banks were generally more compliant than entities in other commercial and not-for-profit sectors.** There is limited demand for financial information from third parties<sup>23</sup>. Tax reporting appears to be the primary purpose of financial reporting and there is a general lack of enforcement from the corporate regulator, due to severe limitations in capacity at the regulators, the preparers, as well as in the profession.

46. **The financial statements of SOEs are generally incomplete, as the law does not require SOEs to follow any financial reporting standards or to have subject to an external audit<sup>24</sup>.** The current law only requires filing of progress reports and, submission to the relevant ministry on a quarterly basis without the requirement to publicly make available any statements. Some of the common issues identified in financial statements of SOEs include i) use of local language with no English translation, ii) sometimes handwritten, iii) not general purpose financial statements but a statement of balances (similar to trial balance), iv) no use of full accrual accounting, v) accounting policies used not stated and, vi) generally unaudited. These shortfalls can be a significant obstacle in the privatization of SOEs, which is an important agenda under consideration of the MOF.

47. **DAB is very active in the performance of its duty as the banking sector regulator. Banking is the only sector where financial statements are comparatively easier to obtain and of comparatively higher quality.** Afghanistan banking laws also require banks to adopt IFRS and an external audit under International Standards on Auditing. Banks are required to file the audited financial statements with the FSD of DAB and to publish the same in the leading national newspapers. Some banks submit schedules defined by the banking prudential regulations as a substitute for “general purpose financial statements”, which is clearly inappropriate as their overall presentation does not comply with IAS 1 “Presentation of financial statements” or with IAS 30 “Disclosures in the financial statements of banks and similar financial institutions”. Furthermore, segment information and related party disclosures are rarely provided. DAB’s own financial statements have at least 10 audit qualifications for both financial years reviewed.

48. **For not-for-profit entities, the quality of the financial statements was again found to be generally more compliant with international accounting standards than other sectors.** This was perhaps due to the stringent requirements of donors related to accurate financial reporting; most of the

<sup>23</sup> Although entities are required to submit their financial statements as part of the loan application process, banks generally base their lending decisions on other factors including the amount of collateral, business forecasts and site visits.

<sup>24</sup> Accounting for an SOE needs to be carried out in compliance with the standard accounting plan and accounting forms approved by the MOF. A progress report on production and financial activities and annual balance sheet are required to be forwarded to the relevant ministry, MOF and to the bank which maintains transactions with the SOE. The financial year of SOEs corresponds to the Solar year. The analysis and evaluation of the economic and financial activities of SOEs are required to be carried out by the relevant ministry and there is no specific provision for an independent audit.

NFP entities reviewed being audited by local Kabul or regional office firms belonging to the large international audit networks, and sometimes developed countries' audit firms signing the NFP entity financial statements from their home country office. Lack of completeness of accounting policies and non-presentation of cash flow statement were the two areas of non-compliance in NFP sector financial statements.

49. **Commercial entities generally do not prepare their financial statements for external financial reporting as there is no legal requirement for filing of audited financial statements along with Income Tax returns.** The situation was different in cases where bank borrowing was involved especially where some entities had hired professional accountants on the insistence of banks who have extended credit facilities to them. Financial statements of seven commercial entities were reviewed. In 6/7, the disclosure of accounting policies was incomplete. In 3/7 there was no cash flow statement, while in one case no comparatives were presented in the cash flow statement. In 2/7, related party disclosures and financial instruments disclosures were not provided. In 4/7, there was no reporting for retirement benefits. In another case no comparatives were presented.

#### IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

50. **In the absence of national standards, audit firms are often expected to follow ISA as required by local legislation, business practice or international network requirements.** To better understand the actual practices, the ROSC team interviewed practicing auditors and held facilitated discussions with the partners representing some of the limited number of audit firms. In most of the larger audit firms, the technical support is provided by regional or other international offices. Due to the acute shortage of accountants in the country, many firms have seconded staff from offices in other countries.

51. **The adoption and application of ISA differs among audit firms.** Our review of the audit reports accompanying some of the financial statements of commercial and NFP entities indicated that there are serious lack of qualified staff of entities in Afghanistan who understand ISA. Many auditors claimed that the directors and top management often fail to adequately appreciate the purpose and value of auditing. Despite efforts by some auditors to carry out audits as per international standards, they view this lack of understanding as a major constraint in discharging their professional responsibilities.

52. **In the case of banks, many audit firms have issued true and fair view opinions (unqualified audit opinions) stating compliance of the accompanying financial statements with IFRS, though there were no general purpose financial statements available but only the reporting schedules for banks as prescribed by DAB.** Lack of general purpose financial statements automatically means non-compliance with IFRS, and therefore the audit opinion is incorrect. Several instances of incorrect qualification of audit opinions also were found. One audit report was qualified for non-verification of inventories and for restricting the audit procedures to the extent of the amounts recorded in the books of accounts; another was qualified for the unverifiable opening balances and unverified inventories and the other was qualified for the completeness of income (donations) which the auditor claims not to be able to verify "by normal audit procedures". In all these cases a disclaimer of opinion or adverse opinion appears more appropriate keeping in mind the pervasive nature of the qualifications and materiality of the amounts involved.

#### V. PERCEPTION OF THE QUALITY OF FINANCIAL REPORTING

53. **There is a general perception that with the exception of banks, the financial statements in Afghanistan are of a very low quality.** The higher quality of the bank's financial statements has been attributed to close monitoring and enforcement by the DAB, restrictive criteria regarding the

qualifications of banks auditors and banks' paying ability to attract highly qualified professionals. On the other hand, the poor quality of the financial statements of other entities is perceived as generally stemming, from limited demand for financial information from third parties, dominance of tax reporting in the absence of other demands, lack of enforcement from the corporate regulator and limited capacity of auditors and accountants. Although entities are required to submit their financial statements as part of the loan application process, banks generally base their lending decisions on other factors including the amount of collateral, business forecasts and site visits.

54. The general perception is that companies that are audited by the local member firms of international audit firm networks have good quality financial information and are generally compliant with IFRS. This is attributed to these companies having the need, ability and/or obligation to pay the price required to obtain the services of a quality auditor.

## **VI. POLICY RECOMMENDATIONS**

55. A sequenced and prioritized action plan, within the overall development framework of Afghanistan needs to be put in place by the National Steering Committee, with clear assignment of responsibility and identification of resources required, that will lay down the roadmap to implement the policy recommendations in this report

56. The policy recommendations outlined in this section have emerged from the review of accounting and auditing practices in Afghanistan, as well as the valuable inputs received from the various stakeholders. These recommendations are expected to provide inputs in preparing the action plan geared towards a quality corporate financial regime in Afghanistan. Implementation of these recommendations will help in:

- i. Enhancing the business climate and attracting domestic or foreign direct investment
- ii. Stimulating growth in the SME sector by facilitating SMEs' access to credit moving from collateral based lending to lending decisions based on financial performance of the prospective borrower.
- iii. Achieving greater financial transparency in the corporate sector. Thus allowing the shareholders and public at large to assess financial and management performance.

57. The policy recommendations in this section are mutually supportive and require holistic, multi-disciplinary approaches for implementation. Implementation will require cooperation from a wide range of stakeholders including Government, regulators, industry, academics, and the accountancy profession and will need to be championed by Government and key development partners. The Government, policymakers and development partners should work together to secure the resources needed to achieve a strong financial reporting infrastructure in Afghanistan. The recommended policy reforms are set out in the following paragraphs and relate to

- Forming a national steering committee led by the government to coordinate the set up of the profession
- Focusing on education and training in accounting and auditing from University level upwards
- Establishing the proposed IAAA and the Temporary Board to set up the IAAA
- Making all laws that impact financial reporting consistent
- Establishing the proposed Accounting and Auditing Board for standard setting.

58. **A National Steering Committee should be established to coordinate the financial reporting and auditing reforms.** The high level National Steering Committee should advise policymakers and regulators on implementation of the recommendations and serve as the ultimate trustees of ensuring that Afghanistan has in place a high quality financial reporting and auditing system. Based on the successful experience of other countries, it is recommended that the Steering Committee should develop a detailed country action plan that clearly sets out sequenced key actions and allocate responsibilities for implementing the necessary reforms. The plan should indicate the resources necessary for successful implementation.

59. **A large scale government led project on education and training in accounting and auditing that is supported by international donors and serves as the foundation underpinning the establishment of the accountancy and auditing profession in Afghanistan is needed.** Unless there are high quality accountants coming out of the education system locally, setting up of an Institute or Regulatory oversight body or financial reporting legislation will have little relevance. Universities and colleges offering degrees and diplomas should be assisted to upgrade their curriculum to a level that will prepare graduates for the professional requirements of accounting and auditing. The curriculum should include accounting standards (IFRS), auditing standards (ISA), and professional (IFAC Code) and business ethics. Technical assistance providers should be engaged for the development of the local accountancy profession and provision of technical assistance to the universities and colleges for upgrading the curriculum. To support the new curriculum, training institutions should be assisted with up-to-date textbooks, access to accounting and auditing standards, and training-of-trainers programs on practical application of IFRS and ISA.

60. **A professional accountancy body should be established<sup>25</sup>.** Several of the shortfalls discussed in this report can be addressed by the establishment of a strong IAAA as a self-regulating, independent professional organization under the coordination of the MOF. For this purpose, the law drafted through the USAID funded project “Capacity Development Project – Private Sector Accounting Reform” in collaboration with MOF, which is a serious effort towards the establishment of IAAA, could be adopted and followed. The A&A ROSC team has analyzed this law and found it practical from the view point of implementation. The law provides a transition mechanism for preparatory actions and recommends a temporary Transitional Board to perform the base work for the smooth functioning of the Institute, after which it will pass over the powers would be passed to a Permanent Board which shall comprise of 11-15 Board members elected from the Institute, by the Central Bank, Chamber of Commerce, Ministry of Finance and Economic Faculty of University of Kabul. Other key actions that should be taken include:

- The professional body should have legal recognition in the financial reporting laws. The legal grounding will make it possible for the body to carry out self-regulatory functions in line with IFAC pronouncements and help the body in instituting and sustaining standards comparable to international good practices.
- Measures should be taken to ensure that the professional body has enough technical and human resource capacity for its functions. This in turn will allow the professional body to establish the due processes, programs and activities to satisfy IFAC’s membership requirements as described in the Statements of Membership Obligations and represent the needs of the profession.
- As a condition for obtaining an audit license, all auditors must be members of the professional body. Appropriate but stringent transitional provisions for membership of unqualified auditors, as well as registering auditors from other ‘equivalent’ jurisdictions would need to be devised.

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<sup>25</sup> International Federation of Accountants Developing Nations Committee has developed a tool entitled "Establishing and Developing a Professional Accountancy Body". The tool can be downloaded without charge from <http://www.ifac.org/Store>.



61. **The professional accountancy body should be responsible for the following functions.**

- **Continuous Professional Development:** As opposed to developing national standards, adopt IFRS and ISA and work on providing accountants in the profession and in industry the training necessary to be able to apply those standards. In this regard the professional body should continuously disseminate information regarding proposed standards, new standards and application of the standards, and organize Continuous Professional Development courses and make CPD compulsory in accordance with IFAC guidelines.
- **Quality Assurance for the profession:** Institute a quality assurance program for accountants in practice through formation of a Quality Oversight Board (QOB), whose initial role should be to help accountants currently in practice bring their practices in line with global best practices and international quality control standards. Composition of the QOB should eventually be from people in active practice and a time frame for the quality assurance program should be defined when the QOB is found its institution. This is so that in the long term the QOB qualifies for International Forum of Independent Audit Regulators (IFIAR) membership, which is necessary to plan for as the Afghan economy integrates with the rest of the world.
- **Public Interest Entity Financial Statements compliance review:** Form a Financial Statements Review Board (FSRB) to regularly examine financial statements of public interest entities<sup>26</sup> for non compliances with accounting standards and for non compliance with auditing standards. Initial consequences for any departures should be a requirement to request for a restatement of the financial statements from the entity and revised audit report from the audit firm to demonstrate action on improving engagement team training, as opposed to sanctions or penalties. As with the QOB, over a period of time, to be defined at the time of establishment of the FSRB, strong sanctions and significant penalties for any departures identified would be desirable.
- **Code of Ethics:** Adopt the IFAC Code of Ethics for Professional Accountants and institute procedures for handling investigative and disciplinary matters under the purview of the IAAA. Provide necessary training and tools for practical application of the standards; assist members to enhance their capabilities in areas identified by the external quality reviews; and handle investigative and disciplinary matters, arising from the external quality assurance reviews conducted by the QOB.
- **Monitoring Accountancy Education & Professional Qualification:** Decide whether Afghanistan would like to develop a domestic accountancy qualification or would like known regional and global institutes to provide their qualifications in the country, and provide recognition once the relevant institute provides a commitment to invest in building training and education facilities in the country. The preferred option amongst all stakeholders seemed to be to adopt a global qualification but retain the right to adopt and name it locally. Either way, the chosen route needs to be in line with IFAC's Education and Training Guidelines.

62. The concept of a Government controlled “Accounting and Auditing Board” to regulate the profession is presently under consideration among the donors and the MOF. This concept was proposed by the Government and also is supported by the Asian Development Bank. The proposed QOB functions can be added to this board

63. **Forge regional and international collaborations for delivering the functions of the QOB and IAAA.** The QOB and the IAAA may not initially have the capacity to execute all of their functions or it may not be efficient to develop some of the capacity required to cater for only the local economy

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<sup>26</sup> Public interest entities are 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.

and profession. Examples of functions that may benefit from regional and international collaboration include practice reviews of auditors, practice development and training, and conducting professional examinations. In this regard, the country should exploit the opportunities for delivering these functions available within the region and internationally through IFAC.

64. **Contradictions exist when multiple laws impact an entity and the laws need to be made consistent.** Under the Insurance Law, insurance companies are required to have their financial statements audited by an internal or external auditor. Whereas the auditor under the draft Law on Accounting and Auditing cannot be an internal person or a stakeholder or one who performs accounting operations for that entity. The adoption of the proposed “Accounting and Auditing Law” as a separate legislation without amending the previously enforced laws will create more confusion and contradictions as there are a lot of differences between the requirements of old and new legislations. Enforcing a new law while keeping the old legislation intact will not be good practice keeping in view of the inconsistencies between the two legislations. For example, the definition of financial statements contained in the draft Law on Accounting and Auditing varies significantly from what is contained in the Commercial Code. Similarly the Commercial Code does not mandate an external audit whereas the draft Law of Accounting and Auditing requires the same. The new Law of Corporations and Limited Liability Companies should be suitably amended to include provisions for the appointment of an independent external auditor, at least for all public interest entities. Although the newly enacted Law of Corporations and Limited Liability Companies requires that the financial statements of companies and corporations to be IAS compliant, it does not mandate an external audit (still relying on the BOS concept with a prescription of mandatory rotation which is not in line with IFAC Code of Ethics or established best practice). Afghanistan should require all entities registered with AISA to have an external audit which would help the profession develop by providing adequate work opportunities, but this needs to be done with taking into account the capacity available in the profession to be able to audit the entities currently registered. The definition of public interest entities for the purpose of external audit applicability should take into consideration the capacity in the profession and the definition should be regularly reviewed as the capacity builds. Furthermore, in the initial years, the proposed Accounting and Auditing Board can prescribe minimum but reasonable audit fees to make audit an attractive business proposition and career choice. It is important that any such prescription is temporary and only prescribes a minimum fee, as opposed to a detailed guide to audit pricing.

65. **Adopt accounting and auditing standards.**

- IFRS should be adopted as accounting standards for all public interest entities. Public interest entities should be clearly defined by QOB in consultation with stakeholders.
- Simplified financial reporting standards (such as the IFRS for SMEs or core IAS standards) should be adopted or set for SMEs. Entities, which do not fall into the definition of public interest entities, will fall into the SME category. There is international acceptance that SMEs require simplified financial reporting standards suiting their size and narrower stakeholder base. The International Accounting Standards Board set simplified accounting standards, which can be adopted for the SMEs in Afghanistan.
- ISA should be mandated for all corporate entity audits. Audit procedures do not really differ with circumstances; therefore ISA should be applicable to all audits. However, IAAA should draw up guidance on application of ISA to entities with characteristics that would categorise them as requiring relatively simple audits, and therefore not require the application of the more complex auditing standards.

66. **Enhance the capacity of all regulators.** Immediate capacity enhancement is required in the information gathering and archiving mechanisms so that the information on entities that operate in Afghanistan and their regular filings are readily accessible. GoA needs to review similar programs implemented in the region with the use of e-governance. Over the medium term, enforcement mechanisms are essential for achieving high-quality financial reporting. The capacity of all regulators should be reviewed. Where necessary, the capacity should be enhanced to enable the regulators effectively handle their responsibilities and IFRS-related issues in public interest entities.

- **The Central Commercial Register.** The Register should have sufficient capacity to track the corporate entities' compliance, or lack of it, with the provisions of the commercial code, on a timely basis. Appropriate technology to enable efficient filing and retrieving of documents will be essential in this regard. The staff in the Registry will need to have up-to-date knowledge of developments in financial reporting requirements.
- **Da Afghanistan Bank.** The Central Bank requires adequate staffing to handle and track compliance of all financial institutions with financial reporting requirements. DAB should also have capacity and expertise to handle IFRS issues relating to the complex fair value standards that financial institutions need to implement. Implementation of prudential regulations in financial institutions closely interacts with IFRS issues. Unless there is an understanding of IFRS issues by both the regulator and the banks and other financial institutions, difficulties will be experienced in reconciling IFRS and regulatory requirements.
- **Privatization and SOEs' Supervising Agencies:** The regulator(s) for state-owned enterprises also should have adequate staffing and appropriate technology to enforce financial reporting requirements of their particular entities. Audit requirements for the different type of SOE's need to be considered; forming a national supreme audit institution to conduct SOEs audits or entirely relying on outsourcing audits of SOE's to the private sector external auditors needs to be evaluated in this light.

67. **Conduct awareness campaigns and related programs.** The objective of the awareness programs should ensure that financial reporting requirements are well understood, and that there is capacity for the implementation of new requirements. Well-planned transition arrangements and good timing for launching the awareness campaign would be essential. The programs should be specifically targeted for the following groups:

- ***The business community.*** The business community should be fully aware of the usefulness of quality financial reporting, and the changes happening locally in financial reporting requirements together with international developments. The business community should also be aware that financial reporting requirements are not a matter of choice but of law, therefore compliance will be compulsory and noncompliance will have penalties.
- ***Directors of companies.*** Company directors should be fully aware of their responsibilities in preparation, audit, and filing of financial statements and the new requirements as well as its enhanced enforcement mechanisms. They should also be aware of the necessity for their organizations to acquire the appropriate expertise in meeting the new requirements.
- ***Directors of finance.*** Finance directors should be fully aware of the requirements for preparation of financial statements. Training programs should be instituted to enhance their



knowledge in handling IFRS and accounting standards. The trainings should be separately targeted for those in public interest entities, SMEs, and the banking and insurance sectors.

- **Auditors.** Auditors should be fully aware of the requirement for all audits to be conducted in compliance with ISA. Training programs should be arranged to ensure all auditors acquire the necessary knowledge required for applying ISA. Audit manuals providing practical guidance on applying ISA should be produced and distributed to all auditors.

