

# REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC) Ukraine

## ACCOUNTING AND AUDITING

August 15, 2002

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#### Executive Summary

This report provides an assessment of accounting and auditing practices in Ukraine within the broader context of institutional capacity available for ensuring high-quality financial reporting. Since its independence in 1991, Ukraine has made commendable progress regarding accounting and auditing standards, especially in the banking sector.

Nonetheless, gaps exist between Ukrainian and International Accounting Standards (IAS), whereby compliance with Ukrainian accounting standards do not result in the same level of transparency and comparability in financial statements that IAS mandates. These gaps include accounting standards applicable to commercial and industrial enterprises (especially disclosure requirements), insurance companies, and to a lesser extent, credit institutions. In addition, several instances of non-compliance in the application of Ukrainian Accounting Standards were noted. These were compounded by sometimes ineffectual mechanisms for enforcing compliance. Opportunities exist for undetected accounting manipulation, financial statements misrepresentation, and deviation from established accounting principles. Compliance gaps were noted in all sectors, although compliance by large credit institutions appears to be better than average.

Although Ukrainian Standards on Auditing were assessed to be largely consistent with International Standards on Auditing (ISA), the analysis detected some important differences. Furthermore, the legal auditing framework is unclear and sometimes conflicts with the auditing standards. In addition, the assessment detected instances of non-compliance with Ukrainian Standards on Auditing; in this regard, the existing enforcement mechanisms require improvement. Immediate steps are recommended to ensure effective enforcement of established statutory requirements and auditing standards.

The report provides policy recommendations, specifically focusing on strengthening enforcement mechanisms to ensure compliance with established accounting and auditing requirements. Moreover, suggestions have been made for important elements of a regulatory framework for the auditing profession, namely restructuring the statutory regulator of the auditing profession under an effective governance structure to efficiently regulate the profession.

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This report was prepared by a staff team from the World Bank on the basis of the findings from a diagnostic review carried out in Ukraine in April 2002. The staff team comprised: Frederic Gielen and Songhan Yoon of the Financial Management Unit of Operations Policy and Country Services. The review was conducted through a participatory process involving various stakeholders in the country.

## I. INTRODUCTION

1. This report is based on a review of corporate-sector accounting and auditing standards and practices in Ukraine. This is part of the World Bank and International Monetary Fund (IMF) joint initiative on Reports on the Observance of Standards and Codes (ROSC). The review process involved an assessment of accounting and auditing standards as designed and as practiced, and an analysis of the effectiveness of the mechanisms for ensuring compliance with these standards. The review used a diagnostic template developed by the World Bank to facilitate assisted self-assessment by national specialists. The self-assessment results—complemented by the findings of a due diligence exercise conducted by World Bank staff—were used in preparing this report.

2. **Sound Financial Architecture.** Accounting and auditing standards and practices are merely one of the pillars of a sound financial architecture. This report summarizes the major characteristics of the Ukrainian economic structure that drives the Bank's recommendations for further enhancement of the accounting and auditing environment in Ukraine. For example, mass privatization that resulted in diffused ownership of more than 36,000 joint-stock companies with 17 million shareholders calls for stringent measures to create effective forms of corporate governance to protect these shareholders. One of the measures enacted by the Ukrainian Government was to require an annual financial audit for more than 35,000 of these joint-stock companies. This report assesses the appropriateness of such requirements and makes recommendations taking into account the specificities of the Ukrainian economic structure, such as the aforementioned diffused ownership.

3. **Improved Economic Performance.** The gross domestic product (GDP) per capita was US\$633 in 2000. In 2001, real GDP grew by approximately 9.1 percent (from 5.7 percent in 2000) after nine years of economic turmoil (1991-1999). Along with this improved economic performance, the National Bank of Ukraine (NBU) brought annual average inflation down from almost 900 percent in 1994 to around 25 percent in 2000, but at a considerable cost in terms of tight credit conditions and high real lending rates.

4. **The Law of Ukraine on Companies (the Company Law) has been amended fourteen times since first promulgated in September 1991.** The Company Law (as amended March 2002) applies to the following legal forms of business entities in Ukraine: joint-stock companies,<sup>1</sup> limited liability companies,<sup>2</sup> companies with additional liability,<sup>3</sup>

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<sup>1</sup> Joint-stock companies are similar in concept to Western corporations (although some important differences remain, such as the absence of provisions protecting the rights of minority shareholders). The Law differentiates between open and closed joint-stock companies. The difference lies primarily in the fact that shares of open joint-stock companies can be distributed through open subscription and can be traded on a stock exchange or over-the-counter, whereas shares of closed joint-stock companies cannot. The liability of shareholders of a joint-stock company is limited to the contribution of the nominal value or issue value of the shares.

<sup>2</sup> A limited liability company has equity capital that consists of predetermined deposits by participants. Participants are liable for the debts of the limited liability company only up to the amounts of their contribution.

<sup>3</sup> An additional liability company has equity capital that consists of predetermined deposits by participants. Participants are liable for the debts of the limited liability company up to the amounts of

general partnerships,<sup>4</sup> and limited partnerships.<sup>5</sup> As joint-stock companies account for over 60 percent of industrial output and the other forms of entities for less than 16 percent (the balance being the government), this report focuses primarily on joint-stock companies, and even more so on listed companies, financial institutions, and other public interest entities.

5. **Investment Capital.** In spite of badly needed investment capital to restructure newly privatized companies, investment activities for the first seven years of independence were constantly shrinking, which in 1997 accounted for only 22 percent of the 1990 level. Since this period, investments started to expand, although they remain low compared to former centrally planned economies in central Europe. The main source of capital investments for enterprises was, and still is, revenues from the enterprises, followed by state and local budgets. By the end of 2000, credits by commercial banks accounted for approximately 2 percent of total financing;<sup>6</sup> and financing through capital markets remained embryonic.<sup>7</sup> Insurance companies<sup>8</sup> and mutual funds do not have significant portfolio investment activities. Though foreign direct investment has been gradually gaining speed since 1999, it remains very low by regional standards.

## II. INSTITUTIONAL FRAMEWORK

### A. Statutory Framework

6. **The legal and regulatory framework is analyzed from two perspectives: whether the legal requirements are adequate, and whether these legal requirements are enforced.** The Ukrainian institutional framework is comprised of laws and regulations as well as five major organizations: the Accounting Methodology Board, the National Bank of Ukraine, the State Commission on Securities and Stock Market, the

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their contribution. However, if this amount is insufficient, participants are personally liable in proportion to their contribution to the equity capital within the limits set out in the company's charter.

<sup>4</sup> A general partnership is a partnership where all the partners are involved in the joint business activity and are jointly and severally liable for the debts of the partnership with all their assets.

<sup>5</sup> A limited partnership is one that has one or more *general partners* who carry out entrepreneurial activities on behalf of the partnership and are liable for the partnership's obligations with all their assets and also includes one or more *limited partners*, whose liability is limited to their contributions.

<sup>6</sup> The banking system in Ukraine is highly fragmented. There are 154 operating banks in the country and the seven largest banks total more than 50 percent of the total assets in the banking system. The total volume of assets in commercial banks as of December 31, 2000, amounted to UAH37 billion (equivalent to approximately US\$7.2 billion), which is less than the assets of a single medium-size West European commercial bank.

<sup>7</sup> Ukrainian stock markets include seven stock exchanges and two over-the-counter electronic trading systems. While comprehensive statistics were not made available to Bank reviewers, total market capitalization appears to be in the range of US\$2 to 3 billion, which is less than five to eight percent of GDP. In addition, equity securities turnover ratio is around 15 percent, reflecting low trading volumes and lack of liquidity. However, market participants believe that securities transactions on the organized markets constitute only a small fraction of the total volume of transactions.

<sup>8</sup> Based on its size, the insurance sector does not create a systemic risk for the financial sector, as compared with the banking sector. There are 330 insurance companies with total earned premiums of US\$623 million. The ratio "premiums/GDP", a measure of the insurance sector penetration rate, was 1.6 percent, well behind the worldwide average of 7.8 percent.

Department of Financial Markets at the Ministry of Finance (regulating insurance companies), and the Chamber of Auditors and Union of Auditors.

7. **Beginning in 1985, accounting and auditing standards and practices in Ukraine became subject to change.** Revision of the legislative framework concerning accounting, financial reporting, and the accountancy profession started in 1991. As a consequence, the legal and regulatory framework underlying accounting and auditing standards setting has changed dramatically over the last decade, and has enabled Ukraine to become part of the international movement toward standardization (e.g., development of Ukrainian Accounting Standards, NBU accounting regulations, and National Standards of Auditing).

8. **The transformation encompasses a multi-level system of accounting and auditing regulation.** At the highest level are the laws of Ukraine, such as the Law of Ukraine on Accounting and Reporting. The second level includes mandatory regulations, such as Resolution 38 of the NBU, “Enactment of Regulations on the Submission of Audit Reports to the National Bank of Ukraine”. The third level includes normative documents, such as accounting standards. The fourth level includes methodological documents, such as supporting materials and instructions to help practitioners. The fifth level includes organizational documents, such as enterprise manuals on accounting policy. While the legislative framework provides that any higher level of standards overrules any lower level, inconsistencies between levels occur and create confusion (e.g., publication deadlines).

9. **The legislative framework of accounting in Ukraine has more features in common with the continental European model than with the Anglo-American model, although it is also gradually moving toward international layouts and norms.** This commonality is most evident because the accounting system as a whole, and even more so the accounting practices, are influenced by the taxable income calculation. While the five-level system has a direct influence on accounting principles and methods, laws and regulations reflecting tax aspects of accounting have an indirect influence. Given that the tax orientation has traditionally been one of the most notable features of the Ukrainian accounting system, many practitioners consider these documents to be among the most important regulations that influence accounting practice (e.g., regarding the establishment of loan loss provisions in the banking sector, the depreciation methods selected by Ukrainian enterprises).

10. **Accounting, financial reporting, and auditing are governed by the Company Law, the Law of Ukraine on Accounting and Reporting (Accounting Law), the Law of Ukraine on Auditing Activity (Audit Law), certain sector-specific laws, and a myriad of circulars and other regulatory documents.** The Company Law specifies the following:

- ***Accounting and financial reporting.*** All companies shall maintain accounting records and prepare financial reports. These financial statements shall be prepared in conformity with Ukrainian Accounting Standards (UAS). UAS

provides simplified accounting and reporting requirements for small enterprises.

- **Auditing.** The “authenticity and completeness of the annual financial statements of a company shall be confirmed by an auditor (an audit firm).” The law provides an exemption for companies with annual revenues less than 250 “non taxable monthly minimum income for an individual” (equivalent to US\$7,800 based on regulations in effect as of July 1, 2002). These companies need to undergo a financial audit only once every three years.

While this framework has permitted major progress in the area of accounting and, to a lesser extent, auditing standards, certain legal requirements fail to achieve their objectives in a number of instances:

- **Unnecessary burden.** They translate into 30,000 to 50,000<sup>9</sup> enterprises being obligated to undergo an annual statutory audit in addition to tax audits by the tax administration. This poses an unnecessary financial and administrative burden on small enterprises.
- **Unenforceable rules.** They are not enforceable because there are too many companies required to have a statutory audit compared to the number of Ukrainian audit professionals. In practice, thousands of enterprises do not comply with these requirements (e.g., a large portion of closed joint-stock companies) without any sanction.
- **Detrimental to quality.** They are detrimental to the quality of the audit profession, both in terms of public perception and of actual work performed, because audit professionals are likely to be under considerable pressure to sign off on one auditor’s report after the other.
- **Silent on appointments and dismissals.** They are silent with respect to the authority to appoint and dismiss the auditor. In practice, the management board usually appoints auditors, though the charter of the company may specify otherwise. The Banking Law specifies that the supervisory board appoints the auditors, but is silent with respect to the dismissal of the auditors.

11. **The Audit Law has been amended twice since first promulgated in 1993.** The Audit Law (as amended February 1996) applies to all legal entities irrespective of their legal form and activity. The definition of an audit given in the Audit Law should have made reference to the scope of audit (e.g., applicable auditing standards) and materiality.

12. **The Audit Law specifies the responsibilities of auditors (sole practitioners) and audit firms.** In the event of noncompliance with their legal or contractual responsibilities, the auditor or the audit firm may be liable to compensate the audited company. The auditor’s or audit firm’s liability shall not exceed the damage incurred by the audited company. A number of audit firms include disclaimer provisions within their

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<sup>9</sup> Estimates of the number of companies are based on the number of existing joint-stock companies (approximately 36,000) and companies incorporated as limited liability companies, companies with additional liability, general partnerships, and limited partnerships. As a significant number of these companies are reported to be dormant or liquidated, estimates regarding the number of companies in existence vary significantly.

engagement letters limiting their liability (e.g., liability capped at the level of the audit fees). There is no legal requirement to have professional indemnity insurance. This framework raises the following concerns:

- ***Unclear responsibility provisions.*** It is not clear whether third parties could sue an auditor or an audit firm under the current Audit Law or under a general law governing damages to third parties.
- ***No professional indemnity insurance.*** The absence of adequate professional indemnity insurance in an environment where net assets of sole practitioners are small and audit firms are typically set up as limited liability companies does not provide a sound basis for compensation of damages.
- ***Contractual liability limitations.*** It is not clear whether the contractual liability limitations embedded in the audit engagement letters would stand up in court.

13. **The Accounting Law establishes an Accounting Methodology Board, which is “composed of highly qualified academia, experts from ministries, enterprises and representatives of professional organizations of accountants and auditors.”** The Accounting Methodology Board is an advisory body to the Ministry of Finance, the statutory accounting standard-setting body, which issues Ukrainian Accounting Standards. This Board also makes recommendations regarding accounting education and continuing professional education for accountants.

14. **The Law of Ukraine on Banks and Banking Activity (the Banking Law)—as amended September 2001—applies to all legal entities that have the exclusive right, based on a license granted by the National Bank of Ukraine, to perform certain banking activities, as defined in the Banking Law and their licenses.** Banks can be founded in the form of joint-stock companies, limited liability companies, or cooperative banks. In any event, the legal provisions that are specific to their respective legal form remain applicable as far as they do not contradict the Banking Law. With respect to banks, the Banking Law and the National Bank of Ukraine have introduced accounting requirements, as well as requirements to provide financial information and audit requirements, which represent considerable progress in relation to the early 1990s. However, there is a common belief among the international financial community that more is required. Among other things, the following aspects need to be addressed:

- ***Legal void.*** The regulatory framework has achieved greater progress in relation to banks than in relation to non-bank financial institutions.<sup>10</sup> The framework presents a legal void in this respect, and may provide banks and others with opportunities for regulatory arbitrage that have been destabilizing for the system as a whole.
- ***Unclear accounting requirements.*** With respect to accounting, the Banking Law specifies, “banks organize accounting in accordance with the internal accounting policy, developed on the basis of the rules and regulations established by the National Bank of Ukraine in accordance with International Accounting Standards (IASS) and regulations (standards) of Ukraine.” In practice, the National Bank requires that all banks prepare their statutory and,

<sup>10</sup> The Banking Law does not apply to non-bank financial institutions.

where appropriate, their consolidated financial statements in conformity with NBU-established accounting rules. In 1998, the National Bank of Ukraine required that certain larger banks also prepare their financial statements in conformity with IAS. This requirement appears to have been gradually waived and only a few banks still prepare two sets of financial statements,<sup>11</sup> as the National Bank asserts that its accounting rules are now compliant with IAS. However, NBU accounting rules fall short of International Accounting Standards in a number of instances. The legal provision stating that NBU rules are developed in accordance with IAS may mislead those who are not informed about NBU accounting rules and who may assume the financial statements that are based on NBU accounting rules present the financial position and results of operations of a bank in accordance with International Accounting Standards.

- ***Unclear audit requirements.*** The Banking Law and applicable regulations also require that banks submit audited annual financial statements to the National Bank of Ukraine. The auditor's report shall include "the bank's balance sheet; income statement; a statement showing certain types of changes in equity; a schedule of assets and liabilities maturity; information as to the adequacy of bank reserves and capital; information as to the adequacy of accounting, internal audit, and control mechanisms; and a conclusion as to whether the submitted financial statements reflect the bank's actual financial position." These provisions do not provide a clear definition of audit requirements—making no reference to the audit framework and not specifying the scope of an audit; for example, that an audit should be conducted in accordance with Ukrainian Standards on Auditing or another comprehensive auditing framework—and do not distinguish between audit and additional requests from the National Bank of Ukraine to the external auditors to assist in specific supervisory tasks.

**15. The Law of Ukraine on Securities and Stock Exchange (the Securities Law) has been amended seven times since first promulgated in June 1991.** The Securities Law (as amended June 1999) applies to all issuers of securities, which include bearer and registered shares of joint-stock companies; and all issuers of debentures, and bearer bonds irrespective of the issuer's legal form. The Law established the State Commission on Securities and Stock Market (SCSSM) as the regulatory agency for all these issuers. Since its inception, the SCSSM has enabled significant progress with respect to accounting and financial reporting. However, it faces a number of structural and practical challenges, impeding further enhancements:

- ***Excessive mandate.*** By comparison with the typical duties of a securities and exchange commission in other countries, its mandate extends well beyond listed companies. The SCSSM regulates and monitors more than 36,000 enterprises in Ukraine. While certain functions of the SCSSM are important (e.g., making financial statements of the joint-stock companies available on its website), some of them ought to be handled by a registrar rather than by the

<sup>11</sup> That is (i) statutory financial statements in conformity with NBU accounting rules; and (ii) financial statements in conformity with International Accounting Standards.

SCSSM, as the current system results in spreading the SCSSM's resources too thinly and weakens its monitoring role and the related enforcement mechanisms.

- ***Inadequate communication requirements.*** In addition to the Company Law publication requirements and the publication requirements described below, the Securities Law mandates that the annual report be mailed to the registered shareholders, which means that 36,000 enterprises are legally obliged to forward an audited annual report to more than 17 million registered shareholders. As this creates an unnecessary burden on enterprises and no enforcement mechanism exists, this publication requirement is often not complied with.
- ***Ineffective publication requirements.*** The issuer must also file its annual report with the SCSSM within nine months of the fiscal year-end (four months for open joint-stock companies) and publish an abridged version of the annual report in one of the official newspapers. The SCSSM publishes such information on its website and makes it available through its Centers for Public Information. While this mechanism was designed to make financial information readily available to external users other than shareholders, (i) the SCSSM to date has been unable to enforce the disclosure requirement for closed joint-stock companies; (ii) in 2000, only 9,876 out of 11,850 open joint-stock companies filed annual reports with the SCSSM; (iii) the requirement to make information available within nine months of the fiscal year-end reduces the relevance of information to dependent users; and (iv) the SCSSM website is designed for disclosure of the primary financial statements only, but not the footnotes, which calls into question its suitability as a platform for the disclosure of International Accounting Standards financial statements.

16. **The Audit Law provides for statutory regulation of the audit profession.** The Audit Law created the Chamber of Auditors (the Chamber) and provided for the establishment of a public professional organization, the Union of Auditors (the Union). The Union nominates ten members to the Chamber of Auditors. Another ten members are nominated by the government from among State departments and academia. The functions of the Chamber include (i) certification of auditors; (ii) approval of auditing standards and education curricula; (iii) management of the national register of audit firms and sole practitioners; and (iv) monitoring of compliance with the Audit Law, auditing standards, and professional ethics.

## **B. The Profession**

17. **There are three accounting/auditing bodies established by law: the Accounting Methodology Board, the Chamber of Auditors, and the Union of Auditors.** In addition, the profession has established a number of professional organizations, including the Federation of Professional Accountants and Auditors of Ukraine.



18. **The Chamber of Auditors is an independent, self-governing body, whose resources consist solely of the auditor certification fees it levies. The Chamber has five permanent employees.** While the achievements of the Chamber of Auditors, since its establishment, are commendable (e.g., the enactment of National Standards on Auditing), the lack of human and financial resources at the Chamber of Auditors hinders its capacity to address the issues faced by the profession in a timely manner.

19. **Only professionals who are registered with the Chamber of Auditors are authorized to act as statutory auditors.** To be registered, an auditor must pass an examination organized by the Chamber of Auditors and obtain a type-A, type-AB or type-B certificate. As of December 31, 2001, there were 3,467 certified auditors,<sup>12</sup> and approximately 1,500 registered audit firms. A certificate is valid for five years after which time it can be renewed under certain conditions. There is a common belief among various observers and practitioners that a significant percentage of the 3,467 certified auditors do not have the professional skills required to conduct an audit in accordance with Ukrainian Standards on Auditing, let alone International Standards on Auditing. This situation is a legacy of the grandfathering process. The Chamber of Auditors is well aware of this issue, and has taken measures to establish a revised examination process and curriculum. This revised examination process and curriculum will apply to new entrants and to existing certified auditors when their certificate expires. However, observers fear that the Chamber may not have the resources or the required independence to impose stringent professional requirements on these existing certified auditors.

20. **While the Banking Law specifies that “the audit of a bank is to be performed by an auditor that has a certificate of the National Bank of Ukraine empowering him to audit banking institutions”, the National Bank of Ukraine has not yet used this prerogative.** At present, a type-B certified auditor registered with the Chamber of Auditors is entitled to act as the statutory auditor for any Ukrainian bank. While the existence of a specific certificate to audit banks (type-B) is commendable in theory, the perceived weaknesses of the Chamber of Auditors certification process, the legacy of the grandfathering process, and the absence of actual accreditation by the National Bank of Ukraine may result in a number of banks appointing incompetent auditors. The National Bank of Ukraine is in the process of taking over the authority to issue type-B certificates.

21. **There are no specific certificate or accreditation requirements regarding the audit of insurance companies and listed companies.** At present, any type-A certified auditor registered with the Chamber of Auditors is entitled to act as the statutory auditor for any insurance or listed company.

22. **The auditing profession in Ukraine lacks credibility and professional competence.** As a result of poor performance by the profession, the public and Ukrainian and foreign institutional investors do not have confidence in the statutory auditor’s report.

23. **Although the local member firms of international accounting networks are present in Ukraine, they perform very few statutory audits, which are usually**

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<sup>12</sup> There were 3,262 type-A, 30 type-AB, and 175 type-B certified auditors.

**performed by local audit firms.** Where an enterprise prepares two sets of financial statements, that is, one set in conformity with Ukrainian Accounting Standards (statutory requirement), and the other in conformity with IAS (on a voluntary basis or to satisfy lenders, foreign investors, or the National Bank of Ukraine), the statutory financial statements may be audited by a local audit firm and the IAS-based financial statements by an international audit firm. International firms are not involved in statutory audits. However, the need to get the international firms "onshore" is pressing, because the non-statutory work they do now is all "offshore", falling outside the scope of any regulatory regime. In this respect, it appears important to relax the current nationality requirements.

24. **Practicing auditors are required to follow the Code of Professional Ethics issued by the Chamber of Auditors in December 1998.** The Chamber of Auditors' Code is a condensed version of the Code of Ethics issued by the International Federation of Accountants (IFAC), as of 1997. However, acknowledging the weaknesses of its former code, in November 2001 IFAC issued a completely revised international Code of Ethics for Professional Accountants. The Chamber of Auditors is currently working on the translation and adoption of the November 2001 IFAC Code<sup>13</sup>.

25. **Ukraine has not yet experienced large-scale litigation against audit practitioners.** There are no reported court cases against auditors.

### **C. Professional Education and Training**

26. **There is a shortage of qualified accounting professionals in the country.** There are approximately 600,000 bookkeepers and accountants in Ukraine. However, key problems include:

- ***General lack of knowledge of UAS.*** There is a general lack of understanding of Ukrainian Accounting Standards and of financial reporting requirements. Since its inception, the Accounting Methodology Board has rapidly developed and enhanced Ukrainian Accounting Standards, which constitute a major change compared to the former Soviet accounting system. While the Accounting Methodology Board has endeavored to accompany the enactment of UAS with training programs and publication in accounting magazines and textbooks published by some of its members, it has not been in a position to set up a comprehensive training program for Ukrainian accountants.
- ***Lack of knowledge of NBU accounting rules.*** While the situation is better in the banking sector, a significant portion of the approximately 25,000 bank accountants also need training to better comprehend the new NBU accounting rules.
- ***Lack of practical experience with IAS.*** Even among the largest enterprises and banks, there is a shortage of qualified accounting professionals with adequate knowledge of International Accounting Standards. In cases where enterprises prepare IAS-based financial statements, international audit firms typically

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<sup>13</sup> This is being done with the assistance of IBTCI under a program funded by the United States Agency for International Development.

coach their clients through the preparation of financial statements. This raises some concerns about risks to audit independence and quality.<sup>14</sup>

A number of initiatives are currently being taken by the Accounting Methodology Board and the Chamber of Auditors with the assistance of a program funded by the U.S. Agency for International Development.

**27. Continuing professional education requirements (40 hours per year) have recently been introduced.** It appears that the Chamber of Auditors would be the only authorized training provider, which raises doubts regarding the quality of the curriculum (among other things, due to the limited resources of the Chamber and the lack of practical experience with International Standards on Auditing).

#### **D. Setting Accounting and Auditing Standards**

**28. The following issues in the accounting standard-setting process should be noted:**

- In spite of the efforts made by the Accounting Methodology Board, gaps continue between local requirements and IAS. This results from (i) ongoing revisions of existing IAS; (ii) enactment of new IAS; (iii) the constant “adaptation” of IAS to local circumstances; and (iv) technical errors in the “translation” of IAS into UAS.<sup>15</sup> Accounting Methodology Board resources are not sufficient to keep up with the ongoing changes and additions to International Accounting Standards. However, as long as IAS are used as recommended below, the issues are less of a problem.
- The Ukrainian standard-setting process by the Accounting Methodology Board is slow and gradual.
- While Ukrainian Accounting Standards and the existing accounting standard-setting process play a significant role for small and medium enterprises, they fall short of the expectations and needs of financial statement users when it comes to banks, insurance companies, listed companies, and any other appropriate public interest entities.

#### **E. Ensuring Compliance with Accounting and Auditing Standards**

**29. Enforcement of accounting and financial reporting requirements in the banking sector appears to be more stringent than in other areas.** However, the perception by institutional investors and credit-rating agencies remains that the National Bank of Ukraine is not as stringent as it should be. To ensure that banks comply with accounting and financial reporting requirements, the NBU relies on bank auditors and on

<sup>14</sup> Recent surveys of IAS financial statements mainly in OECD countries suggest that many instances of noncompliance go unchallenged by the external auditors (primarily large international audit firms). For further details, refer to David Cairns, *International Accounting Standards Survey 2000*, David Cairns International Financial Reporting, Oxon, United Kingdom, 2001 ([www.cairns.co.uk](http://www.cairns.co.uk)).

<sup>15</sup> For example, a detailed review of UAS 13, *Financial Instruments*, revealed a number of conceptual errors compared to IAS 39, *Financial Instruments: Recognition and Measurement*, such as the definition of the “hedging effectiveness ratio”.

reviews of financial reports by the NBU Supervision Department. However, World Bank reviews of a sample of larger banks' statutory financial statements revealed evidence of material noncompliance issues, including errant depreciation of fixed assets, flawed loan loss provisioning, and inaccurate valuation of fixed assets. A sample of larger banks' IAS financial statements also revealed evidence of material noncompliance issues. In both instances, these non-compliance issues had not been reported by the external auditor. These instances highlight weaknesses in the enforcement mechanism and the lack of monitoring of the auditors by the National Bank. The National Bank is considering the introduction of a separate oversight mechanism for type-B auditors, under a World Bank-financed project to strengthen their regulatory capacity .

**30. The Securities Law gives the Securities Commission sufficient power to monitor compliance with legal and accounting requirements and, where appropriate, to resort to relevant sanctions.** However, the Securities Commission lacks the influence, resources and expertise to carry out this function effectively.

**31. At present, the stock exchanges and the over-the-counter markets do not monitor compliance with Ukrainian Accounting Standards and legal or regulatory reporting requirements.** The self-regulatory stock exchanges and over-the-counter markets do not have the legal mandate to regulate financial reporting by the listed companies.

**32. With respect to non-bank financial institutions, such as insurance companies and mutual funds, a special executive regulatory body has yet to be established.** Therefore, there is currently no enforcement mechanism.

**33. While the Chamber of Auditors is trying to establish a practice review system, resources are not adequate, and the system is inefficient.** In the proposed practice review, registered auditors performing the attest function would be subject to review by the Chamber of Auditors. The findings of the assessment conducted by the World Bank and the results of due diligence carried out in connection with the Accounting and Auditing ROSC revealed some other weak links in the system. On certain occasions, statutory auditors failed to comply with Ukrainian Standards on Auditing, and this noncompliance remained undetected by any self-regulatory or statutory regulatory body. The Chamber of Auditors is unable to undertake practice reviews efficiently and effectively, due to its inadequate capacity in terms of staffing and qualifications.

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

**34. Since independence, two major developments occurred with respect to accounting standards: (i) the development of NBU accounting rules, and (ii) the development of Ukrainian Accounting Standards.** While the legislation suggests that these standards are consistent with IAS, a review of the existing standards highlights a couple points:

- ***NBU accounting rules***—developed by the National Bank of Ukraine in cooperation with various donor agencies—are fairly consistent with

International Accounting Standards. However, a number of differences remain.<sup>16</sup>

- ***Ukrainian Accounting Standards*** produce financial statements that are intended principally to meet the information needs of the tax authorities. For example, UAS 7, *Tangible Assets*, permits the use of tax depreciation methods (among other methods) that may not reflect the pattern in which the asset's economic benefits are consumed by the enterprise. Preparers of such financial statements tend to use tax methods where permitted, and do not give much attention to the quality of information that does not directly affect tax computation. UAS financial statements differ materially from IAS financial statements.

In such circumstances, international investors do not base their investment decisions on the financial accounting information in the statutory financial statements unless they transform local accounting numbers into internationally comparable financial accounting information (that is, consistent with IAS). This step means incurring extra costs to do business in Ukraine.

35. **As noted above, there are significant differences between Ukrainian and International Accounting Standards.** Many of the IAS requirements do not exist in Ukrainian accounting requirements. Some differences between Ukrainian Accounting Standards and the International Accounting Standards are described below:

- ***Ukrainian Accounting Standards do not appear to embrace the “comparability” attribute.*** Comparability is necessary for users to evaluate the financial statements of an enterprise over time to identify trends in its financial position and performance. Certain changes in accounting policies were required by the adoption of a new or revised Ukrainian Accounting Standard. Because certain standards became operative (effective) during a fiscal year (rather than at the beginning of a fiscal year as is the case under IAS), users are not in a position to identify differences between the accounting policies for similar transactions and other events used by the same enterprise from period to period and by different enterprises.
- ***The Accounting Law sets out that the going concern is a principle rather than an assumption (IAS).*** Under such circumstances, it is not clear whether an enterprise should prepare its financial statements in the event that circumstances indicate it may not operate as a going concern.
- ***The Ukrainian disclosure requirements are very limited in comparison with IAS.*** Some major differences exist that may mislead a reader who is not well informed about Ukrainian Accounting Standards. For example, sales are reported in the income statement inclusive of value-added tax (UAS 3, *Income Statement*), and there are limited disclosure requirements.

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<sup>16</sup> A World Bank survey of a sample of bank financial statements prepared in conformity with (i) NBU accounting rules, and (ii) IAS in banks that prepared both sets of financial statements in 1999 and 2000 highlighted material differences between the financial statements in the following areas: loan loss provisioning, valuation of fixed assets, foreign exchange results, disclosures, and reporting currency.

- *There is not yet a requirement, as in International Accounting Standards, to identify reportable (business or geographical) segments.* There is also no requirement to disclose detailed information about the reportable segment's revenue, results, assets, and liabilities.
- *Ukrainian disclosure requirements on related-party transactions are not as detailed as those of International Accounting Standards.*

36. **While the design of existing accounting requirements includes a number of shortcomings, noncompliance issues surface frequently.** While observance of accounting standards appears to be better in the banking sector, a number of noncompliance issues were noted in UAS (e.g., noncompliance with NBU rules on fixed assets revaluation) and in IAS financial statements (e.g., noncompliance with certain disclosure requirements of IAS 16, *Property, Plant and Equipment*). These noncompliance issues were noted in financial statements audited by local and international accounting firms. In addition, observance of UAS in the corporate sector appears to be weak. Reviews of financial statements indicate better compliance by larger companies than by small and medium enterprises. Major areas where material noncompliance was noted include disclosure requirements, lack of adequate provisions for doubtful debt, and non-tax-deductible expenses that are charged to equity rather than to income.

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

37. **In December 1998, the Chamber of Auditors, as the statutory body of the auditing profession, issued Ukrainian Standards on Auditing that were based on International Standards on Auditing (ISA).** The following issues should be noted:

- Some International Standards on Auditing were not included in the Ukrainian Standards on Auditing. Two major examples are ISA 402, *Audit consideration relating to entities using service organizations*, and ISA 501, *Audit evidence—additional considerations for specific items*.
- Ukrainian Standards on Auditing do not reflect the changes/additions made in ISA since 1998, for example ISA 570, *Going concern*.

As a consequence, an audit conducted in accordance with Ukrainian Standards on Auditing provides less assurance than an audit conducted in accordance with ISA.

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

38. **Investors generally do not have a high opinion of the quality of information available in published financial statements.** Interviews and discussions with representatives of several institutional investors revealed serious concerns about the quality of financial reporting. In most cases, investors expressed their reservations about the reliability of information contained in the audited statutory financial statements. With regard to improving actual accounting practices in selected areas, most of the interviewees identified the following areas: (i) related-party transactions; (ii) hyperinflation accounting; (iii) segment reporting; (iv) consolidation; and (v) accounting for financial instruments. All the interviewees shared a strong view that the quality of financial reporting would not

be improved unless there is a strong regulatory regime combined with effective enforcement mechanisms to ensure compliance with accounting and auditing standards and the requirements on the auditor's professional ethics.

## **VI. POLICY RECOMMENDATIONS**

39. **This assessment has highlighted two types of issues in Ukraine: weaknesses in the design of the regulatory framework; and implementation of the existing framework and mechanisms.** While this section suggests improvements to the existing regulatory framework, it focuses on strengthening the enforcement mechanisms to ensure compliance with established accounting and auditing requirements, which is a significant weakness of the existing Ukrainian environment. Recommendations are presented in a prioritized approach with the following three objectives:

- Build on the existing system so that recommendations shall not jeopardize the achievements of the current accounting system (that is, with respect to tax collection).
- Promote a gradual process of improvement whereby the financial sector, the listed companies and other public interest entities shall lead the reform process.
- Meet the minimum requirements of the current level of economic and market development, and recognize the necessity of building the foundations for future development in Ukraine.

40. **With respect to legislative and related reforms, the following recommendations are made:**

- Legal accounting and audit definitions/requirements should be clarified. Accounting and audit requirements should be consistent between laws and regulations.
- The main purpose of accounting and financial reporting remains to facilitate computation of taxable profit rather than to meet the information needs of investment decisionmakers and various other stakeholders. This has constrained the development and implementation of rules and regulations that are conducive to high-quality financial reporting in a market economy. While it is essential to maintain and even strengthen tax collection mechanisms (that is, the tax accounting rules that enable the computation of taxable profit and related enforcement mechanisms), a differential view must be taken for those companies where tax accounting does not suffice, including financial institutions, listed companies, and other public interest entities.
- The number of companies subject to audit requirements should be reduced. This recommendation—taken together with the proposal below to give urgent priority to enhancing the quality of ISA audits of IAS financial statements prepared by listed companies, banks, and other public interest entities—points to a smaller but stronger group of auditors, possibly divided into two categories, ISA/IAS auditors and ISA/UAS auditors.

- The provisions establishing the responsibility of the auditors should be clarified. The law should establish the basis for legal action by third parties and require that auditors/audit firms take out professional indemnity insurance.

**41. With respect to prudential requirements, the following recommendations are made:**

- Where the National Bank of Ukraine and other regulators need additional (unpublished) information for prudential supervision purposes, this should be by way of topping-up IAS, not by imposing requirements that conflict with IAS. This approach would make clear the distinction between prudential and general purpose financial reporting. However, since the regulators would have a keen interest in ensuring that the base IAS financial statements are correct—since their reports would be built on that foundation—this would mobilize them to assist in the enforcement of shareholder-/stakeholder-oriented financial statements as well.
- The NBU and the external auditors should cooperate with each other to make their contributions to the supervisory process more efficient and effective. If the NBU requests external auditors to assist in specific supervisory tasks, this should be made in the context of a well-defined framework that is set forth in applicable law (or a contractual agreement between the bank and the NBU). The framework developed by the Basel Committee on Banking Supervision is a sound foundation for establishing such a cooperative approach.<sup>17</sup>
- A non-bank financial institution (or at the very least, an insurance industry) regulatory body should be established.

**42. With respect to accounting standards and the accounting standard-setting process, the legislation should formalize an IAS/UAS split, whereby banks, insurance companies, listed companies, and any other appropriate public interest entities would prepare their consolidated financial statements under IAS,<sup>18</sup> while other enterprises would do so under Ukrainian Accounting Standards.** In this regard, the following would apply:

- The technical capacity of the Accounting Methodology Board, the National Bank of Ukraine, and the non-bank financial institution (or at least insurance) regulatory body (to be established) should be strengthened, especially with respect to their knowledge and practical understanding of International Accounting Standards.
- A due process should be established whereby Ukrainian Accounting Standards are drafted and reviewed with the involvement of preparers and users of

<sup>17</sup> Basel Committee on Banking Supervision, *The Relationship between Banking Supervisors and Banks' External Auditors*, Basel Committee Publication No. 87, Bank for International Settlements, Basel, Switzerland, January 2002, [www.bis.org/](http://www.bis.org/).

<sup>18</sup> In addition to strengthening the financial architecture, the adoption of IAS will meet (a) (i) the needs of an increasing number of Ukrainian companies looking for foreign investment partners; (b) (ii) the needs of an increasing number of Ukrainian banks seeking international ratings; and (c) (iii) the needs of the country, as it seeks closer links with the European Union.



financial statements, including the accounting and auditing profession. Draft accounting standards should be widely circulated and comments discussed by technical committees involving members of the Accounting Methodology Board and representatives of users and preparers of financial statements.

**43. With respect to auditing standards, statutory arrangements should be made for the adoption of all International Standards on Auditing (without modification) as mandatory auditing standards that must be applied by all members of the Chamber of Auditors (replacing existing Ukrainian Standards on Auditing).**

**44. With respect to enforcement mechanisms, the following recommendations would apply:**

- The Securities Commission should become an effective securities regulator and drop from its oversight the tens of thousands of nonlisted/traded companies that consume the bulk of its resources and prevent it from playing any substantive enforcement role. Trade registries could handle these.
- Strong enforcement is key to enhancing the quality of financial reporting and auditing. The banking and listed sectors are those where the public interest is most at stake. This is where the tougher oversight of audit should begin. To avoid problems of jurisdiction with the Chamber of Auditors, and recognizing that the audits of regulated entities are performed by firms rather than individuals, the regulatee should be the audit firm. This should also bring the international network firms onshore, if necessary, by amending the current restrictions on the ownership, management, and control of firms that may be licensed to audit in Ukraine. The NBU should pursue its initiative relating to the introduction of a separate oversight mechanism for Type-B auditors. This could be used as a platform for the more stringent regulation of IAS/ISA auditors. SCSSM partners should also be part of this process.

**45. With respect to publication requirements, the following recommendations are made:**

- Publication requirements should be reviewed realistically. The existing requirement that more than 36,000 enterprises publish their financial statements is not effective.
- For financial institutions, listed companies, and other public interest entities, publication requirements should be strengthened both in terms of quality, timeliness, and availability.

**46. With respect to the profession, the following recommendations are made:**

- The Chamber of Auditors should also be strengthened in its mandate to oversee the entire profession and to license individuals. However, this process is likely to take longer than the more urgent task of sorting out the audit of financial institutions, listed companies, and other public interest entities.
- The professional examination and training arrangements for the potential members of the Chamber of Auditors should be upgraded. They should be

aligned with IFAC education guidelines. Examples are International Education Guideline (IEG) 9, *Prequalification Education, Assessment of Professional Competence, and Experience Requirements of Professional Accountants*; and IEG 10, *Professional Ethics for Accountants*.

- Training programs to improve the expertise of existing members of the Chamber of Auditors should be arranged, with particular emphasis on practical application of International Accounting Standards, International Standards on Auditing, and other international best practice related to audit activities.
- Requirements for continuing professional education should be established, and compliance with the requirements should be enforced. These requirements should be aligned with IEG 2, *Continuing Professional Education*.
- Organized training activities for accountants working in the corporate sector should be extended.
- An arrangement for developing and disseminating implementation guidelines to assist in the practical application of International Accounting Standards and International Standards on Auditing should be established.
- The Chamber of Auditors should adopt the IFAC International Code of Ethics for Professional Accountants as its own national code or use it as a model on which to base national ethical guidance. Should the Chamber use rather than adopt the IFAC code as a model, it should not apply less stringent standards than those stated in the code.
- Stringent rules and enforcement mechanisms should be established to ensure that members of assurance teams, firms, and, when applicable, network firms are independent of assurance clients.
- With the assistance of international experts, the accounting curriculum in all higher education institutions should be reformed, including introducing courses on the practical application of International Accounting Standards, International Standards on Auditing, and the auditor's professional ethics.