REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)

El Salvador

ACCOUNTING AND AUDITING

June 24, 2005

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Executive Summary

El Salvador is actively pursuing a policy of economic integration with its regional partners, especially the US, through free-trade agreements. The country's financial sector is dominated by financial conglomerates with diversified businesses and the local securities market is still in an incipient stage. A privately managed pension system was introduced in 1998.

This report provides an assessment of accounting and auditing practices within El Salvador's corporate sector. It used International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA) as benchmarks, and drew on international experience and good practices in those fields. Both statutory requirements and actual practices were analyzed as part of this review. The purpose of this ROSC is to assist the Government of El Salvador in strengthening the private sector's accounting and auditing practices and financial transparency. The development objectives these efforts address are (a) fostering the growth and accountability of the private sector, (b) ensuring adequate market regulation with respect to the provision of essential services, and (c) making the business environment more attractive for foreign direct investment (FDI).

A Financial Sector Assessment Program (FSAP) Update was conducted in El Salvador in 2004. A considerable ongoing dialogue is being pursued with Salvadoran authorities through follow-up to the FSAP. As a result, the findings of this ROSC regarding accounting standards and related regulatory practices in El Salvador's financial sector will be channelled to the country authorities through the ongoing country dialogue, and thus are not covered in this report.

In 2000, El Salvador decided to adopt IFRS and ISA, which was a good step, consistent with the goal of enhancing the economy's integration in world markets and attract FDI. However, the process for adopting IFRS has been much slower than anticipated due in large part to weaknesses in the regulatory regime and a lack of capacity in the audit profession and the business community.

The main findings of the ROSC Accounting & Auditing in El Salvador follow.

This report was prepared by a World Bank team (LCSFM) on the basis of the findings from a diagnostic review carried out in San Salvador in February and April 2005. The task team was led by Henri Fortin who was assisted by consultants Alfredo Rodriguez Neira as part of the due diligence and Jamil Sopher with regards to quality review. The review was conducted through a participatory process involving various stakeholders led by the Ministry of Finance and coordinated by the Accounting and Audit Oversight Board. This ROSC assessment was cleared for publication by the Technical Secretariat of Presidency on October 6, 2006.

Executive Summary (continued)

Joint stock-companies and limited liability companies represent the overwhelming majority of Salvadoran enterprises, most of which are family-owned businesses. These are required by law to have their annual financial statements audited.

These same companies are required to file their financial statements with the Superintendency of Corporate Obligations (SOM) in addition to several other institutions. Obligations imposed on relatively small business entities tend either to increase the cost of doing business in El Salvador or invite noncompliance with the law. Moreover, the SOM has limited sanctioning powers; its scope of intervention, which includes possibly up to 50,000 enterprises, is too vast and it is not currently equipped to enforce these obligations effectively.

Despite their obligation to have their financial statements audited, the non-listed companies are not required to make these available to third parties (only a copy of the balance sheet without notes is to be filed with the commercial registry, which represents a much more limited information). This makes noncompliance with the law easier, as it is not observable by outsiders. An important objective of corporate financial reporting should be to protect third parties and thereby mitigate the risks associated with corporate failures. Since the public cannot access the financial statements, this objective cannot be achieved.

In 2000, international accounting standards were explicitly incorporated into the country's legal framework. The Accounting and Auditing Oversight Board (CVCA) has established a phased-in adoption schedule for IFRS from 2004 to 2006. Some efforts have been made to prepare companies and auditors for the adoption of IFRS. Yet, the process by which the IFRS standards were adopted did not include a review of each standard to identify which areas would pose the most significant challenges during implementation. Moreover, the CVCA decided that El Salvador would apply the 2003 version of IFRS, which is quite different than the 2004 version.

Currently, the overwhelming majority of licensed auditors do not know the standards well enough to be able to ensure that they are applied by the companies they audit. Moreover, it appears that the companies themselves have not made much effort to prepare for applying IFRS. The ROSC review of a sample of audited financial statements noted a number of differences from IFRS that were not mentioned in the audit reports.

The main requirement for obtaining the license of public accountants and therefore of auditor is a bachelor degree in accounting. No minimum standard has been set for the content of universities' accounting curricula. Neither a professional examination, nor practical experience is required. This does not ensure that licensed practitioners have adequate technical knowledge and professional competence to perform quality audits. Also, the CVCA does not monitor auditors' compliance with ISA. It has plans to introduce periodic quality control but no process has been defined at this point. A continuing professional development obligation for public accountants has been established; however, this obligation is not adequately monitored and sanctions for non-compliance are relatively mild.

The CVCA adopted a Code of Ethics for Public Accountants (*Código de Ética para Contadores Públicos or CEPCP*) in May 2005, based on the 1998 version of IFAC's code of ethics (not the 2005 version). This was an important for improving the accounting and audit practice in El Salvador. Nonetheless, the CEPCP would benefit from further alignment with IFAC's code of ethics, which was thoroughly updated in 2005.

Executive Summary (continued)

More broadly, the CVCA does not have the necessary resources to discharge its functions. At present the CVCA depends almost exclusively on budgetary allocation from the Ministry of Economy. Also, there is no full time, executive level position within the CVCA.

The three Superintendencies within the financial system (SSF, SP and SV) have their own criteria for licensing auditors. They monitor external auditors without coordination with the CVCA. This represents potential duplication of efforts and inconsistencies in the way auditors are regulated. The Superintendencies are also responsible for enforcing accounting standards and financial reporting requirements; however none of them has a specific department dedicated to this activity with specific expertise in international standards.

The recommendations of this ROSC are summarized in the attached table. They are intended to serve as the basis for a country action plan to be developed by the Government of El Salvador in collaboration with in-country stakeholders and with the assistance of the World Bank and other donors.

SUMMARY OF RECOMMENDATIONS					
Description of Action	**Para. no.**	**Responsibility**	**Timing of effective implementation**		
			Short-term (within 1 year)	**Medium-term** (1 to 2 years)	**Long-term** (2 to 4 years)
COMPANIES' ACCOUNTING AND AUDITING OBLIGATIONS					
1. Remove the obligation for SMEs to have their financial statements audited (*)	52	Government			
2. The public should be given access to the financial statements of large non-listed companies with public interest characteristics (*)	58	Government			
ADOPTION OF IFRS					
3. Put in place a detailed transition program for the implementation of IFRS in the enterprise sector	54	CVCA			
4. The CVCA should adopt the most current issue of IFRS instead of the 2003 version	55	CVCA			
5. Enter into cooperative arrangements with other Latin American countries that have adopted IFRS	56	CVCA			
6. Adopt a process of reviewing each new or revised IAS/IFRS standard before it becomes applicable	57	CVCA			
7. Develop a training plan for accountants, both in public practice and in companies	59	CVCA			

(*) Actions likely to require amendments to existing laws – Could be carried out through one legislative action.

SUMMARY OF RECOMMENDATIONS (CONTINUED)					
Description of Action	**Para. no.**	**Responsibility**	**Timing of effective implementation**		
			Short-term (within 1 year)	**Medium-term** (1 to 2 years)	**Long-term** (2 to 4 years)
AUDITOR REGISTRATION AND REGULATION – PROFESSIONAL STANDARDS					
8. Establish a certification system consistent with IFAC-issued education standards, in order to strengthen the licensing requirements for public accountants and auditors. Such system would include: (i) minimum academic requirements; (ii) a three-year professional experience and (iii) the passing of a professional examination.(*)	61	CVCA			
AUDITOR REGISTRATION AND REGULATION – PROFESSIONAL STANDARDS (CONTINUED)					
9. Update the recently adopted code of ethics to reflect the 2005 version of IFAC's code, and ensure its adequate dissemination	60	CVCA			
10. Require all registered public accountants to pay a membership fee	63	MoF, CVCA			
11. Harmonize audit regulation in the financial sector, in terms of registration requirements, independence and required audit procedures	64	Superintendencies (in cooperation with CVCA)			
ENFORCEMENT OF ACCOUNTING AND AUDITING STANDARDS					
12. Establish enforcement guidelines for the Superintendency of Corporate Obligations (SOM), and increase its institutional capacity to carry out its supervisory functions	65	MoE, SOM (in cooperation with CVCA)			
13. Establish a quality assurance system to which all registered public accountants will be subject	62	CVCA			

(*) Actions likely to require amendments to existing laws – Could be carried out through one legislative action.

CURRENCY: US$

MAIN ABBREVIATIONS AND ACRONYMS

AFP	Pension fund administrator
AGM	Annual general meeting
ANEP	National Association of Private Enterprise
BVES	Stock Exchange of El Salvador
CAFTA	Central America Free Trade Agreement
CCES	Association of Accountants of El Salvador
CEPCP	Code of Ethics for Public Accountants
CONAMYPE	National Commission for the Micro and Small Enterprise
CPD	Continuing professional development
CVCA	Accounting and Auditing Oversight Board
FDI	Foreign direct investment
FIRST	Financial Sector Reform and Strengthening Initiative
FSAP	Financial Sector Assessment Program
GAAP	Generally Accepted Accounting Principles
GAAS	Generally Accepted Auditing Standards
GDP	Gross domestic product
IAASB	International Auditing and Assurance Standards Board
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IDB	Inter-American Development Bank
IFAC	International Federation of Accountants
IFRS (NIIF)	International Financial Reporting Standards (*Normas Internacionales de Información Financiera*)
ISA	International Standards on Auditing
ISCP	Salvadoran Institute of Public Accountants
MIF	Multilateral Investment Fund
MoE	Ministry of Economy
MoF	Ministry of Finance
NCB	Accounting Norms for Banks
NCF	Financial Accounting Norms
NCS	Accounting Norms for Insurance
NIF/ES	Financial Reporting Standards Adopted in El Salvador
OECD	Organization for Economic Cooperation and Development
ROSC	Report on the Observance of Standards and Codes
SA	Joint stock company
SA de CV	Joint stock company with variable capital
SME	Small and medium enterprises
SP	Superintendency of Pensions
SV	Superintendency of Securities
SOE	State-owned enterprise
SOM	Superintendency of Corporate Obligations
SSF	Superintendency of the Financial System
UNCTAD	United Nations Conference on Trade and Development

I. BACKGROUND

1. The review of accounting and auditing practices in El Salvador is a part of the World Bank and International Monetary Fund joint initiative on Reports on the Observance of Standards and Codes (ROSC). The review focused on the strengths and weaknesses of the accounting and auditing environment in the corporate sector and how they influence the quality of corporate financial reporting. International Financial Reporting Standards (IFRS)[1] and International Standards on Auditing (ISA),[2] as well as international good practices, were used as benchmarks for this assessment, which covered both statutory requirements and actual practices.

2. **With a population of 6.4 million in 2003, El Salvador is the smallest and most densely populated country in Central America.** The country's main economic sector is services, accounting for 60% of GDP. El Salvador does not a have a broad industrial base, which therefore makes the country highly dependent on imports. Nonetheless, the manufacturing sector has gained importance recently, especially with the emergence of offshore, export-oriented assembly plants dubbed "*maquila*". By contrast, the importance of agriculture, especially coffee crops, has steadily diminished over the last decades.

3. **Over the recent period, El Salvador has experienced a slowdown in its economic growth.** The average GDP increase between 2000 and 2003 was 2%, compared to an average 4.9% in the 1990s—the second highest rate in Latin America during that earlier period. GDP per capita has remained flat at approximately US$2,300 since 2000. This relatively poor recent performance has been mainly the result of external shocks, including the 2001 earthquakes which caused massive destruction, the rise of oil prices, and lower revenues from coffee and *maquila* exports. As a consequence, the trade deficit has been widening since 2000, reaching 15% of GDP in 2003. This trade deficit is being offset by an increasing flow of remittances from the US[3] and, to a lesser extent, by foreign direct investment; however, FDI suffered a sharp decline in 2003, accounting for only 0.5% of GDP, and recovered in 2004 thanks mainly to the sale to foreign investors of a large stake in the formerly state-controlled telecommunications company.

4. **El Salvador actively pursues a policy of economic integration with its regional partners, especially the US, through free-trade agreements.** In 2004, the Government of El Salvador signed the Central American Free Trade Agreement (CAFTA) with the US and four neighboring nations.[4] CAFTA is the principal instrument for El Salvador to achieve greater insertion in world markets as a pillar for private sector led economic growth. The US is by far El Salvador's main trading partner, followed by Guatemala; the US is also the main source of FDI.[5]

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[1] IFRS include (i) the pronouncements issued by the International Accounting Standards Board (IASB), the International Accounting Standards (IAS) issued by IASB's predecessor, the International Accounting Standards Committee, and (iii) related official interpretations. IFRS and ISA have been adopted by a number of countries worldwide, including in Latin America: Costa Rica, the Dominican Republic, Panama and Peru.

[2] Issued by the International Auditing and Assurance Standards Board (IAASB) within the International Federation of Accountants (IFAC).

[3] Remittances amounted to more than US$ 2.5 billion in 2004, representing 16% of GDP.

[4] These countries are: Costa Rica, Guatemala, Honduras, and Nicaragua. The Dominican Republic joined the agreement (which is also now commonly referred to as DR-CAFTA) shortly thereafter. The CAFTA agreement has yet to be ratified by the US Congress.

[5] The US and Guatemala absorbed respectively 67% and 12% of El Salvador's exports in 2002 (source EIU). The US accounted for 33% of accumulated FDI at June 30, 2004, followed by Mexico with 20% and EU countries with 13% as a whole (source: Central Bank of El Salvador).

Formal discussions have also recently begun with the European Union (EU) on a possible free trade agreement with Central American countries.

5. **The adoption of the US Dollar as legal tender in 2001 is an important step toward El Salvador's integration in the world economy.** Adopting the US$ has led to lower inflation and interest rates in the country. This is expected not only to provide fiscal stability to El Salvador, but also to make the country more attractive to foreign investors and facilitate foreign trade for Salvadoran enterprises by eliminating the risks and costs associated with foreign currency fluctuation.

6. **El Salvador is currently facing a high level of external debt, nearing 40% of GDP.** To reduce the country's indebtedness, the government of El Salvador has decided to pursue a fiscally responsible policy, including increasing revenues from taxation. One way to achieve that is to enhance the collection of corporate taxes, which in turn requires curtailing corporate tax evasion. Improving private sector accounting standards and practices supports this objective because more rigorous and reliable accounting records provide better evidence for assessing corporate taxes. Moreover, many tax evasion schemes are often facilitated by loopholes in local accounting policies.

7. **The country's financial sector is dominated by so-called financial conglomerates, with diversified businesses, ranging from commercial banking to insurance.** At the end of 2004, 14 banking groups were present in the country, owning total assets of US$10.6 billion. There were 18 insurance companies with revenues from premiums of US$1.4 billion for 2004. Banks are the primary source of financing to domestic enterprises. Recent legislation has allowed Salvadoran banks to expand their business activities abroad.

8. **The local securities market is still in an incipient stage.** At present, activity on the El Salvador Stock Exchange (*Bolsa de Valores de El Salvador* or BVES) involves mainly trading fixed income instruments, mostly Treasury bonds of Central American states; there is barely any secondary market for equity instruments.[6] Nonetheless, developing the Salvadoran securities market is important in the long run to allow alternative sources of funding for local companies and more diversified investment opportunities domestically. It is foreseeable that the expansion of the capital markets might entail a consolidation of the various exchanges in the region.

9. **A privately managed pension system was introduced in 1998. It replaces a public system which was considered financially unsustainable in the long run.** At the same time the private pension system seeks to encourage long-term savings by public and private sector workers. At the end of 2004, the two private pension funds accredited by the authorities, and which are managed by two of the country's banking groups, held aggregate assets in the amount of about US$2.4 billion. The funds can be invested only in instruments authorized by the Superintendency of Pensions (*Superintendencia de Pensiones* or SP), such as bank notes and debt or equity securities. Such privately managed pension programs imply that the administrators (*administrador de fondo de pensión* or AFP) are accountable to contributors and beneficiaries; this accountability is premised on timely and accurate financial reporting. Moreover, sound

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[6] As of December 31, 2004, there were nominally 50 private entities listed on the El Salvador Stock Exchange (including a few foreign ones). 17 of these were banks (14 not counting banking subsidiaries) and some 20 others were holding companies, or insurance and pension fund management subsidiaries of these banks. The number of (non-financial) enterprises listed on the BVES was 10, all of which domestic companies. Treasury bonds and other public sector securities accounted for 75% of the total volume of trading in 2004 (source BVES).

investment policies imply that pension fund administrators can access reliable and informative financial information from the entities they invest in.

10. **As a result of privatization carried out in the 1990s by successive governments, the state-owned enterprise (SOE) sector is relatively small in El Salvador.** Nowadays the Salvadoran state controls four business enterprises, including the national water utility company, the company operating the San Salvador airport and the country's two main ports company.[7] The State also controls a few financial institutions.

11. **Improving its accounting, financial reporting and auditing practices and effectively aligning them with international standards will support El Salvador's effort to accelerate broad-based, equitable economic growth and increase employment.** Specifically, improved financial reporting would advance the following objectives:

- *Improving the investment climate* – One of the priorities of the Salvadoran Government is to stimulate private sector growth. In order to reach that goal, El Salvador will need to strengthen its accounting and auditing practices as non-resident investors require financial information with sufficient quality, detail, and trustworthiness, as a pre-requisite for any significant investment decision. The further alignment of corporate financial reporting practices—including, as was the case in the EU recently,[8] the effective implementation of IFRS—is an essential condition of broadening the country's appeal to external investors.
- *Facilitating the growth of enterprises especially small and medium ones (SMEs) by enhancing their ability to access credit* – The Government of El Salvador would like more remittances from abroad to be channeled into investments especially for the creation of SMEs. Improved credit analysis would facilitate SME access to borrowing especially from foreign lenders.[9] In both cases, those Salvadoran SMEs seeking access to financing will have to provide sufficient and credible information of their financial condition and performance to potential lenders and investors.
- *Supporting the development of the privately managed pension funds system* – Increasing the quality and reliability of corporate financial reporting will create opportunities for pension fund managers to diversify their investments into private sector securities, thereby reducing their dependence on the banking sector and offering prospects to increase average returns on investment.
- *Greater economic integration on regional and international levels* – This will require the accelerated convergence of standards and practices among the CAFTA partners, especially with the US. In order to achieve greater integration with the major trading blocks, El Salvador needs to adopt and implement effectively internationally recognized rules and practices for business activities, including standards of accounting and auditing. Moreover, institutional development and governance are needed to give the perception as well as the reality that the country has reliable laws and regulations, and that it is

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[7] *Administración Nacional de Acueductos y Alcantarillados* (ANDA) and *Comisión Ejecutiva Portuaria Autónoma* (CEPA). In addition, *Comisión Ejecutiva Hidroeléctrica del Río Lempa* (CEL), a state entity, is charge with the management of the country's dams. A fourth SOE runs the national lottery.

[8] Since January 1, 2005, all listed companies within the 25 member states of the EU are required to apply IFRS in preparing their group financial statements.

[9] A recently completed Investment Climate Assessment (ICA) in El Salvador pointed to the presence of high collateral requirements (for amounts significantly higher than the loan itself, on average) as a constraint to SME access to finance.

determined to curb corruption. By ensuring greater transparency and making more difficult the concealment of illicit transactions, strengthened accounting and auditing practices will contribute to enhancing the benefits from CAFTA.

- *Mitigating the risks of financial crises and the associated negative impact on the economy*, since the dependability of the financial reporting by enterprises directly affects the banking sector's ability to assess properly the quality of their loan portfolio.
- *Fiscal consolidation* – Since corporate income tax is determined on the basis of the companies' accounts, the ability of the Salvadoran State to increase its revenues from taxation depends on the quality of applicable accounting standards and on effective compliance with those standards by corporate taxpayers.
- *Increasing the accountability of purveyors of essential public services, which are now provided by private enterprises* (e.g., in the telecommunications and electricity sectors). Accordingly, higher standards of accountability and governance are a key to ensuring consumers have adequate access to services of acceptable quality. Such standards of accountability and governance include accounting and financial reporting, since the financial statements are essential tools for monitoring the operating performance and financial health of utilities and other public services providers.

12. **In this context, the ROSC Accounting & Auditing in El Salvador seeks to support the Government's efforts to strengthen corporate standards of governance as a means to address the following three strategic objectives:**

(a) ***Foster the growth and accountability of the private sector,***

(b) ***Ensure adequate market regulation,*** both in the financial sector and with respect to the provision of essential services, and

(c) ***Make the business environment more attractive for FDI.***

13. A Financial Sector Assessment Program (FSAP) Update was conducted in El Salvador in 2004. A considerable dialogue has been initiated on that basis with Salvadoran authorities. At this stage, the findings of this ROSC regarding accounting standards and related regulatory practices in El Salvador's financial sector will be channeled to the country authorities through the existing dialogue. Consequently, the report does not cover accounting and regulatory practices in the financial sector.

II. INSTITUTIONAL FRAMEWORK FOR PRIVATE SECTOR ACCOUNTING AND AUDITING

A. Statutory Framework

14. **The law in El Salvador subjects a large number of companies, including small businesses, to the same requirements in terms of accounting and auditing.** Accounting, financial reporting and auditing requirements for private, non-financial enterprises in El Salvador are governed by the Code of Commerce of 1970 as amended 1993 and related regulations.[10] The Code contemplates various forms of corporate entities, the most commonly used by far being the joint-stock company with variable capital *(sociedad anónima de capital variable* or SA de CV*),* mainly because it allows relatively simple processes for increasing or reducing capital. Enterprises with less than 20 shareholders may be incorporated as a limited liability company (*sociedade de responsabilidad limitada*), although such legal form is in effect seldom used in El Salvador. Under the Code, all joint stock companies must prepare annual financial statements, including a balance sheet, income statement, statements of changes in equity and related notes in accordance with "the evaluation criteria and accounting principles issued or authorized by the Accounting and Auditing Monitoring Board (*Consejo de Vigilancia de la Profesión de Contaduría Pública y de Auditoría* or CVPCA) or, by default, International Accounting Standards" (differences between accounting standards prevailing in El Salvador and IFRS are discussed in Paras. 31, 38 and 39). The annual financial statements of all SAs must be audited before they are presented at the shareholders' annual general meeting (AGM; per Art. 289). Moreover, external auditors in SAs have extensive responsibilities including "verifying at all times the company's operations". Auditors are required to attend the AGM (Art. 291), which gives shareholders the opportunity to seek clarification of the financial statements, thus contributing to investors' confidence. As for *limitadas,* they are also required to appoint an external auditor (Art. 122). The fact that small businesses are subject to relatively stringent financial reporting requirements represents a cost of doing business with no clear corresponding benefits for the society.

15. **Listed companies, which by law include banks, insurance companies and pension funds, are subject to specific laws and regulations[11] prescribing accounting standards and rules for purposes of both supervision and external reporting.** By law all banks and insurance companies must be listed on the BVES. Besides general provisions in the respective laws, questions pertaining to accounting, financial reporting and auditing are dealt with in the regulations of the Superintendencies of (i) the Financial System (*Superintendencia del Sistema Financiero* or SSF, which covers insurance), (ii) Securities (*Superintendencia de Valores* or SV) and (iii) Pensions (SP, Para. 9). Except for listed enterprises (i.e., non-financial companies, which are under the purview of SV), these regulations include compulsory charts of accounts, models of financial statements, and methods for accounting transactions of particular relevance to each market, including valuation of securities or real estate assets and loan loss provisioning (Para. 38). No distinction is made between regulatory financial reporting and general-purpose financial

[10] Decree no. 671 of May 8, 1970, which was thoroughly amended since then, including on accounting matters.

[11] These laws include: the banking law (legislative decree no. 697) issued September 2, 1999; the insurance company law enacted January 1, 1997; the non-banking financial intermediaries law enacted July 1, 2001; securities market law (legislative decree no. 809) issued December 6, 2001; and the pension funds law (*Ley del Sistema de Ahorro para Pensiones,* legislative decree no. 927) issued December 19, 1996.

reporting. All the above mentioned entities must subject their annual financial statements to an independent audit. In terms of financial reporting, the following obligations apply:

(a) ***For banks***:

- Audited, annual financial statements are to be submitted to SSF and published in a large circulation national newspaper no later than 60 days after year-end; an SSF Norm (NCB-017[12]) regulates the form and content of the financial statements as well as the accounting standards to be applied. These are defined as "International Accounting Standards and accounting norms issued by the Superintendency of the Financial System, the latter prevailing in case of conflict." NCB-017 provides an overview of accounting treatments to be applied on key aspects, and a model of financial statements to be followed by banks, with a set of minimum explanatory notes.
- Half-year and quarterly financial statements (unaudited) at June 30 are to be submitted to SSF and published within a month;
- Monthly financial statements (unaudited) are to be submitted to SSF electronically within five business days;
- Weekly financial statements and other information are to be furnished for regulatory purposes; and
- A variety of data on the loan portfolio and other matters as prescribed in SSF's prudential norms are also required to be made available.

(b) ***For insurance companies,*** similar requirements as the ones for banks apply, including a norm on the preparation of the financial statements (NCS-015) which mirrors NCB-017; sector-specific information to be reported includes a breakdown of investments and the auditor's report on the liability adequacy test.

(c) ***For listed enterprises,*** the following must be submitted to SV:

- Annual, audited and half-year, unaudited financial statements within 45 days;
- Quarterly, unaudited financial statements at March 31 and September 30 within 30 days;
- Information on changes in the company's capital, in accounting policies, etc. must be provided on an ongoing basis.

(d) ***For pension funds and AFPs,*** there are also reporting requirements regarding (i) annual, audited financial statements, which are due on February 10 of the following year; (ii) half-year and quarterly unaudited financial statements (due within 15 days); (iii) monthly financial reports (due within seven days); (iv) and different daily reports to be submitted to the SP on an ongoing basis.

16. **In the banking and insurance sectors, independent auditors are subject to specific registration requirements and regulations pertaining to the conduct of their audits.** SSF requires a minimum of five years of experience—for a sole practitioner, or for one of the partners in the case of an audit firm—and knowledge of the Statements of Auditing Standards (SAS) issued by the American Institute of Certified Public Accountants. Once the registration is approved, SSF updates its list of approved auditors, which currently includes 37 individuals or firms for banks (29 for non-banking financial institutions and 23 for insurance companies). A firm cannot audit an institution with which it has any outstanding borrowings and cannot derive more than 25% of its revenues from one audit client.[13] Rotation of the persons in charge of the

[12] Accounting Norm for Banks (*Norma Contable para Bancos* or NCB) no. 017, issued February 7, 2001.
[13] SSF Norms for Registration of Auditors (NBP 2-06) dated March 20, 2002.

audit is required after five years. Moreover, SSF's External Audit Norms for Banks and Insurance Companies (NBP2-05) provide detailed requirements on the conduct of audits, including: a) conduct audits applying SAS (see above in this Para.; Art. 19); b) submitting an audit plan to the SSF within one month after appointment, indicating the audit procedures contemplated on specific aspects[14] (Art. 20-22); c) evaluating the internal control system and issuing a specific report thereon (Art. 25-26). In terms of reporting, SSF requires that the auditor's opinion be issued with reference to International Accounting Standards (IAS, since then incorporated into IFRS) and SSF Norms or, if there are differences with IAS/IFRS, to disclose them in the audit report (Art. 33).

17. **Requirements on external auditors, albeit less stringent, also exist for pension funds, AFPs and listed (non-financial) enterprises.** In the pension fund sector, these requirements are set in a Presidential Decree,[15] which is less demanding and prescriptive than in the banking or insurance sectors: for instance, no minimum experience is required for auditors; much less emphasis is placed on internal controls; and the regulations require "auditing standards" to be applied in the conduct of audits, without further precision. As for listed enterprises, three years of experience are required, but no rotation of the audit team is prescribed.[16] Six audit firms were registered with SP as of April 2005 and 25 individuals and firms were registered with the SV.[17] Based on the above, external auditors in the financial sector are subject to different regulations and must apply for separate registrations. This represents redundant procedures both for auditors and regulators. A single process for registering auditors would be more cost efficient as in essence, the qualifications expected from external auditors are broadly the same in the different segments of the financial sector. A proposed merger of the three Superintendencies into a single SSF is being discussed currently at the Legislative Assembly; this could provide an opportunity to unify the registration process and harmonize auditor regulation. Furthermore, the regulations do not provide a sufficient system for selecting auditors, and therefore regulators should seek to promote a system of certification as was done in Mexico with the endorsement of the securities and banking supervisor and the insurance supervisor.

18. **Companies above a certain size are required by the tax law[18] to provide a certification by an independent auditor regarding compliance with their tax obligations.** The auditor must be registered with the CVPCPA and can be the same as the one auditing the corporate financial statements. The tax compliance reports (*dictamen e informe fiscales*) must be submitted to the tax authorities no later than May 31 of the following year. The CVCA has issued a norm on how tax-purpose audits should be conducted.[19]

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[14] The issues for which some audit procedures are explicitly required include: (i) assets subject to credit risk, (ii) compliance with prudential standards, (iii) third-party confirmations; (iv) various accounts that must be tested as per the SSF Norms and (v) IT systems.

[15] Presidential Decree no. 8 of January 21, 1998 on external audit services in AFPs and privately managed pensions funds.

[16] Instruction AE30/1994 issued June 16, 1994 by the Managing Board of SSF (which then regulated the securities market, until this area of supervision was spun-off into a separate Superintendency, the SV); Instruction AE48-1997 issued October 16, 1997 by the Managing Board of SV.

[17] For each of the three Superintendencies, the lists of auditors can be accessed to through the respective websites.

[18] Legislative decree no. 230, December 14, 2001, Articles 129-138. These requirements apply particularly to companies with assets in excess of 10 million *Colones*; (approximately US$ 1.1 million) or revenues in excess of 5 million *Colones* (approximately US$ 0.6 million). One US$ is equivalent to 8.7 *Colones*.

[19] *Norma para el Cumplimiento de Obligaciones Tributarias*.

19. **SOEs must report using government accounting standards.** The previously mentioned SOEs (Para. 9) are incorporated until special statutes, and do not fall within the scope of the Code of Commerce. As part of recently issued *Guidelines on Corporate Governance of State-Owned Enterprises,* the Organization for Economic Cooperation and Development (OECD) has recommended that "large or listed SOEs should disclose financial and non-financial information according to high quality internationally recognized standards". Similarly, both the IASB and its public sector counterpart[20] advocate the application of IFRS by "government business enterprises" (SOEs whose activities are mainly commercial). The financial information on SOEs as published currently by the MoF would have to be expanded significantly to meet the requirements of IFRS in terms of presentation and disclosure.

20. **Listed companies are required to publish year-end financial statements whereas non-listed companies are only to deposit their year-end balance-sheet without any notes to the commercial registry.** Banks, insurance companies and other listed companies must make public disclosure of their annual and half-year accounts in a large circulation newspaper.[21] Such publication must take place no later then 60 days after the end of the respective reporting period. With respect to non-listed enterprises, the Code of Commerce requires that they file their annual balance sheet with the government-administered Commercial Registry (*Registro de Comercio*).[22] The public can have access to this information through the National Registration Center. However, a balance sheet provides incomplete information and is not sufficient for third parties to carry out adequate analysis regarding the financial condition of an enterprise and therefore does not provide a sufficient basis for properly informed investment or business decisions.

21. **At the same time, non-listed companies are subject to multiple filing requirements in relation to their financial statements.** SAs and *limitadas* must file their annual financial statements with the Superintendency of Corporate Obligations (*Superintendencia de Obligaciones Mercantiles* or SOM), an entity within the MoE. In addition, companies are required to provide financial information to several other institutions including the Commercial Registry (Para.20) , statistics department in the Ministry of Economy, tax authorities and line Ministries for public procurement. However, the filings with SOM are considered confidential and therefore not accessible to the public or any third party. The law does not require non-listed companies' annual full financial statements (i.e. including an income statement, a statement of cash flows and accompanying notes) to be made available to the public. The unavailability of adequiate financial information except for a very small number of enterprises (approximately 10) makes sectoral analyses difficult if possible at all, and exposes the smaller creditors who are not able to obtain a copy of the financial statements to a greater level of risk as they cannot necessarily ascertain the financial condition of their debtors. This impedes investing, lending and, to a certain extent, commercial activities in the private sector.

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[20] The International Public Sector Accounting Standards Board (IPSASB), an independent board within IFAC.

[21] Banking law Art. 224; Insurance law Art. 87 (same as for banks); and Securities Market law Art 34 (for the latter, publication in widely circulated, financial gazettes is a permitted alternative).

[22] Code of Commerce (Decree no. 671), Art. 459, 467 and 474.

B. The Accounting and Audit Profession

22. **Accounting and audit in El Salvador is a reserved profession placed under the oversight of the CVCA.** The CVCA was established in 2000 through a specific piece of legislation (referred to in this report as the "Accounting Law"[23]). Article 1 of the Accounting Law provides the official definitions of "public accounting", "external audit" and "independent audit of financial statements", some of which are not fully aligned with those of IFAC. The role of the CVCA includes: (a) registration of public accountants (including auditors), which basically requires a university degree; (b) oversight of the professional practice and ensuring practitioners are indeed registered; (c) setting minimum requirements for auditing, and monitor compliance by auditors; (d) setting accounting and financial reporting standards and authorizing internationally accepted accounting principles and auditing standards; (e) issuing a professional ethics code; (f) investigating any complaint regarding non-compliance with legal requirements and professional practice; and (g) promoting continuing education among public accountants. This wide range of responsibilities is consistent with those of most accounting profession oversight boards worldwide,[24] a possible exception being accounting standard-setting, a function that is often assigned to a separate, specialized body. There were some 3,000 individuals registered as accountants with the CVCA as of December 2004, half of whom were currently practicing; in addition, 202 accounting firms were registered with the CVCA.

23. **The CVCA has limited resources to conduct its oversight and standard-setting functions.** According to the Accounting Law, the CVCA is a six-member Board whose President is appointed by the Ministry of Economy, and its other five members are appointed respectively by (i) the MoF, (ii) the National Association of Private Enterprise (*Asociación Nacional de la Empresa Privada* or ANEP), (iii) the SSF and SV jointly, and (iv) each of the two accounting professional associations (CCES and ISCP). The CVCA has a technical staff of four and an administrative staff of five. It does not have a permanent executive. Its annual budget of US$110,000 (for 2004) is provided by the State budget. Select members of the profession contribute their time on a *pro bono* basis. Licensed professionals are not required to pay an annual fee to keep their registration, which explains why an estimated 50% are registered.

24. **Neither professional experience nor the passing of a professional examination are pre-requisites for registration as public accountant.** Besides certain conditions of form, the main substantive requirement for registration as an individual accountant is a college degree in accounting issued by one of the country's universities with an accounting curriculum (Accounting Law, Art. 3-a). In contrast, international good practice as codified in IFAC's International Education Standards for Professional Accountants (IES), requires both a three-year professional experience and a professional exam.[25] The implication is that the license of public accountant (individual) can be awarded to persons whose technical capability and professional competence to carry-out audits of adequate quality has not been properly established. For the registration of an accounting firm, the latter must have one partner or owner registered as a public accountant (as an individual) and, if the accounting firm is affiliated with an international network, it must file a copy of the membership agreement with the CVCA (Accounting Law, Art. 3-b and 15). There are no conditions set in the law regarding the legal structure of accounting firms, which can be

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[23] *Ley Reguladora del Ejercicio de la Contaduría* (legislative decree no. 828), enacted on February 29, 2000.

[24] Most OECD countries have set-up such boards in the recent period. A small number of emerging economies (e.g., Mauritius and Sri Lanka) have established one.

[25] IES 5, *Practical Experienced Requirements* and IES 6, *Assessment of Professional Capabilities and Competence* (October 2003).

incorporated as SA de CV (i.e. with limited liability). Based on interviews with a number of regulators and stakeholders, a large number of practicing auditors do not possess up-to-date technical knowledge and practice of international standards that would allow them to apply IFRS and conduct audits in accordance with ISA. This calls for increased continuing professional education efforts on the part of the profession.

25. **The accounting profession has two officially recognized, voluntary associations,** the Salvadoran Institute of Public Accountants (*Instituto Salvadoreño de Contadores Públicos* or ISCP) and the Association of Accountants of El Salvador (*Corporación de Contadores de El Salvador* or CCES). These organizations have been established for many years and they play an important role in representing the profession in the country. They are members of IFAC[26] and the Inter-American Association of Accountants (a regional body with no standard-setting or regulatory role). Both associations organize some seminars for their members on professional issues regarding accounting and auditing standards. One of the challenges for the profession at present is to increase the relatively low demand for audit services, which limits its ability to generate revenues and therefore develop practitioners' technical knowledge. In this context, the professional organizations also suffer from scarce resources; even though some of their members do contribute to the CVCA's activities, they cannot play an active role in the development of the accounting and audit practice in El Salvador.

26. **Three of the large international accounting firms ("Big 4") dominate the market for audit services to listed companies in El Salvador.** A majority of banks, insurance companies, pension funds, and other listed enterprises, have one of the Big 4 as their statutory auditor. Other international networks are represented in the country. These firms and their representatives have played an active role in the process of adopting international standards, supporting the work of the CVCA and providing some training to other practitioners through the CCES or the ISCP.

27. **The CVCA issued the Code of Ethics for Public Accountants (*Código de Ética para Contadores Públicos* or CEPCP) in May 2005, based on the 1998 version of IFAC's code. This was an important for improving the accounting and audit practice in El Salvador.** An adequate code of ethics is essential to ensure that licensed auditors perform their function observing the fundamental principles of integrity, objectivity, competence, due care, confidentiality and independence. As such, the code of ethics is an essential component of a profession's credibility vis-à-vis the users of the financial reporting who rely on auditors. The Code of Ethics for Public Accountants issued May 6, 2005 governs both individual accountants and firms, which mirrors the two categories of entities that can be registered with the CVCA. The CEPCP describes the fundamental principles that govern the professional practice, which are in line with IFAC's Code of Ethics (amended 2005) except that (a) it does not identify the fundamental principle of integrity and (b) it includes "economic retribution" as a fundamental principle. The CEPCP could be improved in terms of clarity and alignment with IFAC's code.[27] Its implementation will require adequate dissemination, both within the profession and in the academic community, to ensure that it is properly understood and applied.

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[26] On the list of members posted on IFAC's website, ISCP is mentioned as "suspended", which normally indicates that the member organization has not settled its membership fees.

[27] One of the areas of desirable alignment with IFAC's code has to do with independence. The CEPCP states that one form of impairment of independence is receipt of 25% of total revenues from one client for more than three years. Instead of this type of prohibition, IFAC's Code of Ethics suggests a "threats and safeguards" approach to the risk of economic dependence vis-à-vis an audit client.

C. Professional Education and Training

28. **In their current state, accounting curricula in El Salvador do not adequately prepare students for the use of international standards.** Most Salvadoran universities offer an accounting curriculum, the content of which is up to them to define; there are no minimum requirements regarding this content. Accordingly, the title of bachelor in public accountant does not reflect a homogeneous level of academic formation. Universities are faced with limited resources and professors need to dedicate a substantial portion of their professional time to the practice. Based on interviews conducted with the accounting faculty at three leading local universities, those universities have yet to integrate IFRS and ISA in their accounting curricula. Moreover, the professors in the accounting departments of universities need to be trained in IFRS and ISA, as these contain concepts which for the most part they have not had the opportunity to apply. There is very limited cooperation between universities and the profession's representative bodies on issues involving accounting education and standards.

29. **The CVCA has established requirements for continuing professional development (CPD) for professional accountants.** Among the functions assigned to the CVCA by the Accounting Law, one is promoting continuing education (Art. 36). Accordingly, the CVCA has issued a Resolution on April 25, 2003, which establishes (i) a minimum number of 20 hours of CPD per year; (ii) the types of acceptable CPD activities (workshops, seminars, conferences, etc.); (iii) the subject matters to be covered by CPD (auditing, accounting, tax, IT, ethics, etc.—IAS and ISA are explicitly mentioned as basic topics to be addressed); and (iv) a Continuing Education Commission in charge of defining the policy in terms of education and accrediting CPD courses. The CVCA can accredit the following institutions for CPD activities: professional associations, universities and organizations specializing in professional training. In-house training courses can also be recognized by the CVCA. Licensed practitioners and technical staff are both subject to the CPD obligation. Sanctions for non-compliance include a written reprimand for the first year and a fine of three, six and 12 monthly minimum wages (respectively for the second year, third year and beyond; which represents respectively US$475, US$950 and US$1,900 approximately[28]). These sanctions appear relatively low, especially compared to similar sanctions for similar circumstances in other countries (e.g., in the US, the audit profession's oversight board can impose, on first instances of non-compliance, fines of up to $100,000 for individuals and $2 million for firms), and may not be able to deter non-compliance effectively.

D. Setting General-Purpose Accounting and Auditing Standards

30. **Until recently, there was no official definition of accounting standards for private enterprises in El Salvador.** Until the CVCA was established in 2000, the code of commerce did not stipulate what accounting principles were to be followed by companies in preparing their annual financial statements. In the 1990s, the accounting profession in El Salvador developed a set of 23 Financial Accounting Norms (*Normas de Contabilidad Financiera* or NCF), mostly inspired by US Financial Accounting Standards (FAS). No statistics exist on this matter, but it is believed that most enterprises previously applied Mexican GAAP, NCF, or policies based on a mix of these standards.

[28] One monthly minimum wage is equivalent to US$ 158.4.

31. **El Salvador has been moving since 2000 toward adopting IFRS; nevertheless, a lack of preparedness by interested parties has caused adoption to be delayed several times.** There were four major milestones in the process for adopting IFRS in El Salvador since 2000, as follows:

(i) On December 5, 2000, the CVCA issued a Resolution (*Acuerdo*) requiring all corporate entities in El Salvador to apply International Accounting Standards (IAS, since then incorporated into IFRS) for fiscal years starting on or after January 1, 2002.

(ii) On January 1, 2002, in light of what appeared to be the low degree of preparedness of Salvadoran companies and accountants before the transition date, the CVCA granted a one-year extension for the application of IFRS. Nonetheless, companies were required to "show the differences existing between accounting practices at the time and International Accounting Standards, including their quantification".

(iii) On December 5, 2003, the CVCA issued a Resolution by which it (i) postponed the application of IFRS to the year 2004 and (ii) set out a schedule for phasing-in the norms between 2004 and 2006 (2004 for listed companies, 2005 for large non-listed companies and 2006 for SMEs—under the assumption that, by then, a set of simplified international standards would be available[29]).

(iv) On December 22, 2004, the CVCA issued a new Resolution to (a) exempt SSF-regulated companies (i.e., banks, insurance, etc.) from the requirements to apply IFRS and (b) to clarify that the version of IFRS to be applied was the one issued by the IASB in 2003; since the 2003 version of IFRS had been superseded by a new version (IFRS 2004) and to avoid possible confusion, the standards to be applied were referred to as Financial Reporting Standards Adopted in El Salvador ("NIF/ES"[30]).

The current financial reporting requirements on Salvadoran corporate entities resulting from this process are summarized in Table 1.

[29] The IASB has initiated in the fall of 2003 a project to develop a set of "SME standards" on the basis of IFRS (or "simplified IFRS").

[30] *Normas de Información Financiera Adoptadas en El Salvador*.

Table 1 – Accounting standards required by type of business entity

Type of entity	Applicable standard prior to IFRS	Year of implementation – Applicable standard	
		Per previous CVCA Resolution (December 5, 2003)	Per current CVCA Resolution (December 22, 2004)
Listed companies except those regulated by SSF	No legal definition	2004 – full IFRS	2004 – NIF/ES
Companies regulated by SSF	SSF Norms	2004 – full IFRS	SSF Norms, IFRS otherwise
Large[31] non-listed enterprises		2005 – full IFRS	2005 – NIF/ES
Small and medium enterprises (SMEs[31])	No legal definition	2006 – "SME" IFRS	2006 – "SME" IFRS
Very small businesses		Exempt from applying IFRS	
Pension funds and AFPs	SP Norms	Outside the scope of CVCA – SP Norms apply	
SOEs	Government accounting standards		

32. **The CVCA's decision to give more time for companies, auditors and users of financial statements to be prepared for using IFRS appears fully justified. Even so, repeated delays in the adoption raise several issues:**

- ***The process for the adoption of IFRS did not include essential activities such*** as: (i) thoroughly analyzing each IFRS standard and interpretation to identify the main difficulties they pose in relations to prevailing standards, especially the NCF; (ii) conducting surveys of the accounting profession to assess the state of their knowledge of IFRS; and (iii) requiring companies to test the application of IFRS on prior year accounts and monitor such tests. Moreover, the deployment of IFRS was not managed according to a detailed plan with a sequence of key activities (reviewing of standards, training of company accountants, "real life" testing of IFRS). Accordingly, the adoption process followed in El Salvador could not ensure that companies and auditors would be adequately prepared respectively to apply and enforce IFRS. As a result, there is a widespread view that most companies are not ready to apply IFRS. To illustrate that situation, regarding listed enterprises, the SV had to award an extended deadline for these companies to file their annual audited financial statements as of December 31, 2004, from February 15 to June 30, 2005.

- ***Existing material for the implementation of the standards is useful but not sufficient.*** Following its decision to require IFRS for all small to large enterprises, the CVCA and the accounting organizations have made commendable efforts to promote seminars on IFRS, but these events cannot be construed as training courses properly speaking. With regards to the material needed to train accountants in public practice or in business,

[31] Large enterprises as well as SMEs are defined according to the criteria set by the National Commission for the Micro and Small Enterprise (*Comisión Nacional para la Micro y Pequeña Empresa* or CONAMYPE), as follows:
- Small enterprise: (i) between 11 and 50 employees and (ii) annual sales equivalent to 476.2 to 4,762 monthly minimum wages;
- Medium-sized enterprise: (i) between 51 and 200 employees and (ii) annual sales equivalent to 4,762 to 31,746 monthly minimum wages (equivalent to US$ 750,000 to US$ 5 million).

CVCA developed a guidance manual in February 2005.[32] The guidance manual does not specify whether certain options permitted by IFRS should not be followed, provides templates of financial statements and accompanying notes and contains a questionnaire aimed at helping companies to evaluate whether a series of IFRS requirements apply to them. Added to the existing application and implementation guidance issued by IASB itself, the guidance manual is a useful document. Nevertheless, it cannot replace a training manual, which needs to be much more thorough and detailed, as recent experience in the EU has shown.

- ***Decisions in the past to postpone the application of IFRS were taken too close to the deadline for implementation.*** Both in 2003 and 2004, the CVCA's Resolution occurred almost at the end of the year. This has fostered a perception of complacency in the accounting profession and among companies, who do not appear to have used the additional time provided to take the necessary steps to prepare for IFRS.
- ***The IFRS version adopted (referred to as NIF/ES) presents numerous differences with the new version issued by the IASB in 2004.*** The 2004 version of IFRS which is the one used in Europe and most countries that have adopted IFRS, contains 5 new standards (IFRSs 1 to 5), two pre-existing standards have been withdrawn (IASs 22 and 35) and 13 IASs have been modified, sometimes on very important aspects. Consequently, all the efforts that need to be made to adopt NIF/ES would not achieve one of the key objectives of the IFRS project in El Salvador which is international comparability and, to a certain extent, credibility of the financial information (further details in Para. 38).
- ***In their current levels CVCA's resources do not appear sufficient for it to conduct its standard-setting functions effectively.*** CVCA depends exclusively on state budget to fund its standard-setting and oversight responsibilities.

Based on the above, even though some important steps in the right direction have been taken, the whole adoption process and the time scheduled for deployment of IFRS need to be re-thought. These repeated delays and continuing difficulties in implementing IFRS put at risk the objective of improving the quality of the accounting practice in El Salvador.

E. Enforcement of Accounting and Auditing Standards

33. **The three financial sector Superintendencies enforce accounting and financial reporting requirements although in varying degrees.** At the SSF, Monitoring of accounting and auditing is conducted mainly during visits by the On-site Inspections Department (with separate teams for the banking and insurance sectors). Inspectors can have access to auditors' work papers. Under the Banking Law, management, employees and auditors can be prosecuted for felony in case of intentional misstatements in the financial statements (Art. 210) and auditors can incur a fine or have their license suspended or repealed for non-compliance with their obligations (Art. 226). The Insurance Law has similar provisions. Regarding listed companies, the SV performs two types of controls: (i) review of financial statements filed with SV's Registration Department and (ii) on-site inspections by the Supervision and Control Department. Enforcement is primarily focused on particular events such as initial public offerings of debt issuance. Moreover, the impact of enforcement actions is difficult to measure as there is no history of restatement of financial statements by regulated entities as a result of inspections or reviews. In relation to pension funds and AFPs, the SP conducts on-site reviews of audit firms as part of its

[32] *Guía de Orientación para la Aplicación de las Normas de Información Financiera Adoptadas en El Salvador*, February 2005.

annual audit plans. SSF has imposed fines on auditors for late submission of reports or incomplete planning memoranda (US$2,000); two have seen their license not renewed for lack of documentation. Overall, sanctions are both rare and light, and they are not published.

34. **The Superintendencies have no specific department or resources dedicated to the function of reviewing financial statements.** It can be argued that the size of the markets, especially the stock exchange, does not provide a critical mass for a strong enforcement of financial reporting obligations, considering the high degree of accounting expertise required, especially with the adoption of IFRS. In that regard, a common enforcement department dedicated to accounting, supported by sectoral supervision departments (banking, insurance, enterprises) seems the best solution to achieve such critical mass.[33]

35. **The Superintendency of Corporate Obligations (SOM) faces severe capacity constraints which hamper its effectiveness.** The number of entities SOM is supposed to monitor is estimated at 30,000 to 50,000. SOM is not equipped, whether in terms of IT system or human resources, to adequately oversee such a large population of corporate entities. For instance, the SOM is currently not able to track late filings and filings with qualified audit reports, both of which should trigger enforcement actions. A large part of its activities consists in receiving the filings and storing them. The SOM does not have any electronic storing facility. It has a staff of 10 inspectors who conduct on-site views. It also sends reminder letters to companies who do not comply with filing deadlines. Yet the sanctions it can impose are reprimands for first cases of non-compliance and fines equivalent to 15 to 50 monthly minimum wages (between US$2,100 and 7,500). These sanctions have limited deterring effect. Similar institutions as the SOM in other Latin America have been facing the same challenge of having a large number of entities placed under their supervision by the law, with budget constraints limiting their ability to carry out that role. In Ecuador, the solution applied was to limit the supervision to companies above a certain size.

36. **The CVCA does not currently monitor licensed auditors' compliance with their professional obligations but is considering introducing a quality assurance system.** The CVCA conducted in 2004 an experiment in the form of interviews by a team of professionals from Mexico, covering 16 firms, on a voluntary basis, and with a very limited scope (for instance, it did not include reviewing audit files). This first attempt was well perceived within the profession and outside. The CVCA is now considering establishing a system of quality review by accredited professionals, though no process has been defined yet in that regard. [***Addendum (June 2006):*** subsequently to the completion of this ROSC, the CVCA has increased its efforts to monitor the audit practice in El Salvador. In the fall of 2005, inspections were conducted at 40 audit firms by a team of 32 CVCA-appointed reviewers. During these inspections, a particular focus was placed on compliance with International Standard of Quality Control (ISQC) no. 1, as well as on issues of documentation of audit evidence and audit conclusions. Additional details can be obtained directly from the CVCA. These efforts represent an excellent step toward the introduction of a robust system of monitoring within the audit profession].

37. **Cooperation between the various regulatory agencies concerned by accounting and auditing needs to be enhanced.** SSF and SV being represented on the CVCA, there is an existing institutional relationship between them and CVCA. However, the content of such relationship is not formally defined, in terms of exchanges of information and other forms of

[33] They concept of combining enforcement of accounting and financial reporting powers into one specialized institution is relatively new on an international level. It has been implemented in the UK in 2004 with the creation of the *Financial Reporting Council*.

cooperation. The SOM does not have any relations with the CVCA even though (a) the SOM is charged with enforcing the standards CVCA establishes and (b) virtually all entities under the purview of the SOM are supposed to be audited, while at the same time CVCA supervises auditors. Cooperation between the two institutions would create synergies and make each institution's enforcement more efficient. For instance, the SOM should be able to report to CVCA cases where the role of auditors could be questioned, which could trigger actions by the CVCA and would be a useful input in establishing its annual quality review program. Also, SOM could provide statistics to CVCA on which companies are audited by which audit firms, as this would help CVCA better monitor the Salvadoran public accountancy profession, including on issues of market concentration, and practitioners' dependence on a small number of clients.

III. ACCOUNTING STANDARDS AS DESIGNED AND AS APPLIED

38. **As previously noted (Para. 32), the version of IFRS which large Salvadoran enterprises are required to apply in 2005 differs substantially with, and is considered of lesser quality than, the most recent issue.** IFRS were thoroughly revamped by the IASB in 2005 at the request of international stakeholders, as part of an improvement project which aimed to: (i) reduce the differences between IFRS and US GAAP as part of a convergence process mutually agreed with the US standard-setter; and (ii) take account of the lessons drawn from experience of using IFRS (which had been fairly untested until the beginning of this decade, as only a few countries had mandated the use of IFRS until then) and of the requests by international investors and stakeholders to fix the standards on certain aspects.[34] The main differences between NIF/ES (i.e. IFRS 2003) and the improved version (IFRS 2004) relate to the following issues and transactions:

- *a.* ***Presentation of the financial statements*** *(IAS 1)* – Several changes have been made by IASB on this standard, including eliminating the notion of non-operating (or exceptional) items in the income statement, as it was considered prone to manipulation.
- *b.* ***Accounting policies, changes in accounting estimates and errors*** *(IAS 8)* – The new version of IAS 8 is more rigorous on the need to disclose the effects on changes in accounting policies and corrections of prior period errors.[35]
- *c.* ***Business combinations*** *(IFRS 3, superseding IAS 22)* – Under the new standard, the goodwill resulting from an acquisition should not be amortized any longer; instead, the amount of goodwill is to be tested each year for impairment, resulting in a charge in the income statement only if such impairment is found to exist.
- *d.* ***Related-party disclosures*** *(IAS 24)* – These disclosures have been strengthened especially with regards to management compensation and the obligation for management to substantiate the assertion that related-party transactions were concluded on an arm's length basis.
- *e.* ***Financial instruments*** *(IAS 32 and 39)* – These standards, which stirred much controversy recently especially in the banking sector when they were issued, have been amended on a number of aspects in 2004.

[34] One of the reasons for improving IFRS was that they would be mandated for all listed companies in the EU in 2005, which dramatically increases the scope of application of IFRS in the private sector on a worldwide scale. Also, Australia and New Zealand will require IFRS respectively in 2005 and 2007.

[35] Moreover, IFRS 1, *First-time Adoption of International Financial Reporting Standards*, which was already applicable in 2003, has been excluded from NIF/ES. IFRS 1 is meant to facilitate the transition from another GAAP without sometimes having to revisit certain transactions occurred several years before. The exclusion of IFRS 1 could make the adoption of NIF/ES more difficult.

f. ***Alternative treatments*** – Several alternative accounting treatments that IFRS 2003 allowed have been eliminated in the 2004 version, including (i) the Last-In First-Out method for valuing inventories, (ii) the capitalization of exchange losses, and (iii) the presentation of correction of errors as part of the current year earnings.

These differences described above can hinder the comparability of Salvadoran enterprises' financial information especially for investors with an international background.

39. **The review of a sample of the financial statements issued by Salvadoran enterprises showed significant gaps between actual practice and IFRS 2003.** The ROSC assessment included the review of a sample of 18 audited financial statements of Salvadoran enterprises (i.e. non-financial) as of December 31, 2004 or 2003. This review purports to identify apparent misstatements in the financial statements; it cannot identify errors or irregularities in terms of recognition, measurement and, to a lesser extent, of disclosure, as only an independent audit can achieve that. The review cannot give any form of assurance with regard to the accuracy and reliability of the financial statements. Considering the limited number of listed enterprises in El Salvador (10) the sample needed to include non-listed enterprises, whose financial statements are audited but not published (Para. 20). The main observations arising from the review can be summarized as follows:

(a) ***Several key accounting concepts of IFRS were not used in the preparation of the financial statements.*** The most significant of these concepts include:

i. *The use of fair value*, to measure a wide range of assets and liabilities, including financial instruments, investment property and biological assets. In most cases these elements are stated at cost or not reflected at all on the balance sheet of Salvadoran companies. This leads to the understatement, or overstatement, of a company's equity, which is a key indicator of its solvency.[36]

ii. *Deferred taxation* – Usually, under local tax laws and regulations, certain transactions are accounted for at a different time as they are recorded for tax purposes (thereby generating a temporary difference between the accounting books and the tax return). In such cases, IAS 12, *Income taxes* requires that a deferred tax asset (or liability) be recognized, with certain conditions in the case of a deferred tax asset relating to the probability to recover it. In the financial statements reviewed, the notion of deferred tax was not applied, with two exceptions. This issue is particularly relevant in the case of companies that revalue their property, as failing to recognize the implicit tax effect of a revaluation leads to inflating the equity value of the company.

iii. *Impairment* – This notion which consists of reflecting the decrease in value of certain assets is equally important to financial statement users' ability to accurately measure the financial performance and situation of a company.

(b) ***On several aspects, the accounting practice observed was either not in accordance with IFRS or not consistently applied from one company to another.*** Treatments departing from IFRS included: (i) revaluations of fixed assets not updated periodically, (ii) recognition of revenue without meeting the conditions set in IAS 18, *Revenue*, (iii) inventory valuation not in accordance with the lower of cost and market value,[37] and (iv)

[36] For instance, one company mentioned in the notes to the financial statements the existence of outstanding forward contracts for purchases of goods with market value below purchase price. The company would have had to recognize the corresponding loss under IFRS.

[37] See also the discussion of a related issue in Para. 43.

the capitalization of interest without satisfying some of the requirements of IAS 23, *Borrowing costs*. Furthermore, with respect to the indemnity owed to employees upon dismissal under Salvadoran labor law, many companies seem to follow the practice of paying such indemnity even when the employee retires; but only a few recognize a liability on their balance sheet as IAS 19, *Employee benefits* would require.[38]

(c) ***On average the quality of the disclosure did not meet the requirements of IFRS.*** This was particularly the case for the disclosure of accounting policies followed, and explanatory notes on contingencies, related parties, the terms of borrowings, etc.

40. **Based on the above, the quality of the information provided in the financial statements reviewed is uneven and in several cases that information would likely not fully meet the needs of investors and lender.** The financial statements of the few listed enterprises that had applied NIF/ES (i.e. IFRS 2003) had greater precision, clarity and comparability. On the whole, the effective implementation of IFRS would significantly improve the usefulness of the financial statements for external users, which is a condition to foster the development of lending activities and investment in Salvadoran companies. Bridging the gaps described above will require significant training on the part of accountants in business and in public practice. Moreover, business managers are seldom aware of the importance of these issues. This is all the more problematic as a high quality financial reporting regime depends on accurate inputs from managers, especially to ensure the proper underlying economic rationale of certain accounting treatments (for instance regarding issues of valuation of inventories, which directly depends a variety of business factors, or to determine whether a long-term asset is impaired and to measure the corresponding loss of value).

41. **Except for two listed companies which applied NIF/ES, the financial statements reviewed all indicated that the company was in the process of evaluating the impact of IFRS, but none provided any evidence that they had actually made such an evaluation. This clearly departs from one of CVCA's requirements, which is that companies must disclose the impact of differences with IFRS (Para. 31 (ii)).** Even though companies were not legally required to quantify differences between existing accounting methods and IFRS, the fact that most of them indicated they were still in the process of doing so is somewhat worrisome. Indeed, experience in other countries that have undergone a transition from local GAAP to IFRS shows that earnest attempts to perform such quantification was done much ahead of time, often more than a year before the planned date of transition. This seems to point to the need for closer monitoring by the CVCA of Salvadoran companies' efforts to implement IFRS.

IV. AUDITING STANDARDS AND PRACTICES

42. **Auditors in El Salvador are required to apply International Standards on Auditing (ISA) for all financial statement audits.** The CVCA adopted ISA in 2000. As previously noted, the CVCA commissioned a survey of the audit practice in El Salvador consisting of a series of interviews with representatives of 16 local audit firms. The main issues arising from this survey included: (a) the lack of clearly defined, written policies with regard to independence; (b) the absence of evidence that audit partners and staff are adequately trained; (c) the planning of audit engagements is insufficiently documented; particularly, most audit arrangement letters did not

[38] There is also a discussion about whether or not a provision in the Code of commerce should be interpreted as an obligation for companies to recognize a provision for such labor commitments ("*obligaciones laborales*"). According to Salvadoran authorities, this issue needs to be analyzed in light of the provisions of IAS 19 and according to each company's individual situation.

meet the requirements of ISA 210, *Terms of audit engagements*; (d) the documentation of audit work and the supervision of such work needs improvement; and (e) few audit firms have put in place a policy of documenting the conditions for accepting new clients and retaining existing ones; also it is unclear to what extent the practice of communicating with the predecessor auditor (recommended by ISA 510, *Initial engagements*) is actually followed.

43. **The analysis of the audit reports relating to the financial statements covered by the ROSC review raises several questions on the quality of the audit practice,** as follows:

- ***Qualified opinions*** – Four audit reports contained qualifications in the form of scope limitations or exceptions.[39] The most notable issues are as follows:
    a) In the case of a listed enterprise, the auditor qualified its opinion on two issues regarding receivables of doubtful collectibility. The auditor also mentioned in its report two issues that appear to be as serious, if not more, as the two others.[40] In one of the cases, it seems clear that the auditor should have objected to the treatment followed instead of just emphasizing the issue at the end of the report.
    b) The audit report on one bank had four scope limitations and three exceptions, which is an unusually high number and calls into question whether or not the financial statements present fairly the financial position of the company.
- ***Mention of related-party transactions*** – A significant number of audit reports included an "emphasis of matter" paragraph, in addition to the three standard paragraphs, on the following issue: "the Company is part of an economic group, and it is possible that the terms of the transactions within the group are not the same ones as would have been set between totally independent entities". This type of mention does not meet the criteria for an "emphasis of matter" paragraph, and does not provide clear and useful information for the reader.
- ***The text of the reports did not always adhere to the IAASB model.*** Statutory audits reports, which are official certificates, should strictly follow the wording prescribed in ISA 700, *The Auditor's Report on Financial Statements*.
- ***Description of reporting framework applied*** – As noted above, the financial statements reviewed did not include the quantification of differences between the financial reporting applied and IFRS (in some case, no information was provided at all), even though both the CVCA and SSF require such quantification. None of the audit reports included a qualification on this point. Moreover, several audit reports described the accounting basis applied by banks in a way that suggested IFRS was being followed although it clearly

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[39] *Scope limitations* represent procedures which the auditor deems necessary in order to conduct the audit in accordance with ISA or other applicable standards, but which could not be carried. *Exceptions* are issues regarding which the auditor disagrees with the accounting treatment followed by the company.

[40] The two issues can be briefly described as follows:
(i) The company stated a certain category of inventory on its balance sheet at production cost, which happened to be higher than market value. Under any acceptable set of GAAP, inventories cannot be carried on the balance sheet at higher than market value (otherwise the sale of the inventory will generate a loss). The justification provided by the notes to the financial statements for such treatment was that it followed an industry practice. However, good accounting practice should take precedence over any alleged industry practice (which should be adjusted to meet the general principles of sound accounting).
(ii) The audit report underscored a disclosure in the financial statements about the fact that a financial valuation had been made in the past of the company as a whole, showing a lower value than the net book value. However, no further element was provided on this matter to allow the reader to make appropriate use of this information.

was not the case. This further underscores the lack of preparedness of enterprises and banks for the adoption of IFRS and calls for stronger enforcement on the part of the regulators.

44. **The environment within which the auditing process is developed in El Salvador is not conducive to external auditors' compliance with ISA and limits their accountability vis-à-vis financial statements users.** Based on the interviews conducted by the ROSC team with audit practitioners, regulators and other stakeholders in San Salvador, the most significant factors constraining the application of the standards are:

- ***The financial statements of non-listed companies, which are audited, cannot be accessed by third parties*** (Para. 20). This limits the risk for outside auditors to be challenged with respect to the fulfillment of their professional obligations and standards.[41]
- ***There is no history or tradition of civil lawsuits against errant auditors.*** Additionally, no professional insurance covering external auditors' exposure to legal recourse by financial statements users is required from external auditors, either by law or by regulations.[42] Except to some extent in the financial sector, the law does not specify an external auditor's liability for misconduct and the improper discharge of their professional responsibilities.
- ***Audit quality control*** – As previously noted (Para. 36), there is no mechanism in place to ensure that auditors (individuals or firms) comply with auditing standards and observe internal quality assurance procedures as prescribed by international standards (ISA 220, *Quality Control for Audit Work*).
- ***Weaknesses in the enforcement regime for corporate financial reporting*** – Especially in the case of non-listed companies, the current shortcomings in the enforcement regime are also a contributing factor to auditors' limited exposure to actions against them in case of inadequate audits.
- ***Lack of interest on the part of the business community for corporate financial reporting*** **–** Salvadoran companies are still largely family-owned and the business community generally sees limited interest in external financial reporting, when it does not perceive such reporting to be a possible threat to business secrets. Moreover, regarding the governance structure of Salvadoran companies, audit committees are almost non-existent at the moment.

Taken as whole, these factors weaken the incentive for quality in audit work and increase the likelihood that audits could be inadequate to ensure high quality published financial statements. Overall, the level of the auditing practice in El Salvador appears uneven and many weaknesses need to be addressed by the CVCA to ensure that enterprises comply with IFRS, so that the objective of enhancing financial transparency in the private sector can be achieved.

V. PERCEPTIONS ON THE QUALITY OF FINANCIAL REPORTING

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[41] If audited financial statements were published in full, misstatements such as those discussed in Para. 39 could be more easily detected by third parties; under such arrangements, external auditors would be deterred not to report on instances of non-compliance.

[42] However, those audit firms that are members of international networks are usually covered under an international arrangement.

45. **Stakeholders have mixed views of the quality of corporate financial information in El Salvador and have concern regarding the lack of availability of financial statements for all enterprises, except a few listed ones.** Overall, financial statement users (credit departments of commercial banks, brokerage firms, rating agencies, investors) and other in-country stakeholders interviewed as part of this ROSC consider the quality of corporate information acceptable for listed companies and insufficient for non-listed enterprises. Moreover, the fact that no financial information on privately-owned enterprises is either published or accessible through a public register is seen as a major impediment to sectoral analyses. On the stock market, some pointed to disclosures on related-party transactions as an area requiring improvement.

46. **There is a clear perception that companies and banks are not ready for IFRS and need to become better prepared as a prerequisite to moving to that standard.** The adoption of IFRS by all large enterprises and SMEs (albeit in a simplified version for the latter) is viewed as a move likely to be positive, but posing a major challenge for Salvadoran enterprises, requiring a higher degree of awareness on the part of the business community. In the financial sector, implementing IFRS is expected to require some investment in IT systems and to generate material impacts. A gradual approach while the banks and the regulators develop needed capacity appears to make a lot of sense.

47. **Some stakeholders call for a more effective and transparent enforcement on the part of regulatory agencies, especially the SOM.** The role of the financial sector and capital market Superintendencies is viewed favorably on the whole, although more transparency with respect to sanctions is called for by various market participants. The proposed merger of the three Superintendencies is expected to provide economies of scale and bring simplification. SOM is clearly perceived as lacking resources to discharge its function and act as an effective deterrent.

VI. FINDINGS AND RECOMMENDATIONS

A. Summary of Observations

48. **In 2000, El Salvador decided to adopt international standards of accounting (IFRS) and auditing (ISA) to strengthen corporate financial reporting in the country.** Such a decision was a good step, consistent with El Salvador's goal to enhance the integration of its economy in world markets and attract FDI. Indeed, both sets of standards are internationally recognized and apt to provide financial information of high quality; in addition, developing its own standards entails considerable recurring costs for a country and goes against the objective of ensuring maximum comparability in business practices. However, the process for adopting IFRS has been much slower than anticipated due in large part to weaknesses in the regulatory regime and a lack of capacity in the audit profession and the business community. The principal findings arising from the ROSC Accounting & Auditing in El Salvador are summarized hereafter:

COMPANIES' ACCOUNTING AND AUDITING OBLIGATIONS

(a) Joint stock-companies (SAs) and limited liability companies (*limitadas*), which represent the overwhelming majority of Salvadoran enterprises, are required to have their annual financial statements audited. Since among these companies there are numerous family-owned businesses, this means that, in effect, a very large number of SMEs are required to have an audit of their financial statements. In practice, because external audits involve a relatively high cost, they are generally performed only for public interest entities (i.e.

listed companies, banks and large non-listed enterprises). Such a comprehensive audit requirement either leads to increase the cost of doing business in El Salvador, or invites noncompliance with the law.

(b) These same companies are required to file their financial statements with the Superintendency of Corporate Obligations (SOM) in addition to several other institutions including the National Registry, statistics department in the Ministry of Economy, tax authorities and line Ministries for public procurement. Multiple filings increase the cost of doing business in El Salvador. They also represent redundant costs for the State who has to process them.

(c) Except for listed companies which include some 10 enterprises, corporate financial statements are not available to third parties. This makes noncompliance with the law easier as it is not observable by outsiders. An important objective of corporate financial reporting should be to protect third parties and thereby mitigate the risks of corporate failure. Since the public cannot access the financial statements, and because the SOM is not presently equipped to play an enforcing role effectively, this objective cannot be achieved

ADOPTION OF IFRS

(d) El Salvador's code of commerce was amended in 2000 to incorporate international accounting standards explicitly into the country's legal framework. The country's official standard setter, the Accounting and Auditing Oversight Board (CVCA), has adopted IFRS in 2000. A phased-in adoption schedule has been set in December 2003 and revised in December 2004 as follows:

- 2004 (calendar year, which coincides with fiscal year): adoption by all listed enterprises (banks and insurance companies which were previously included are exempt until further notice);
- 2005: adoption by large, non-listed enterprises;
- 2006: adoption by SMEs.

(e) Since 2000, some efforts have been made to prepare companies and auditors for the adoption of IFRS, mainly in the form of seminars and workshops. In 2005, the CVCA developed a guidance material for the use of IFRS; however, such material has been limited due to the associated costs and to the CVCA's lack of adequate financial and human resources. The process by which the IFRS standards were adopted did not include a review of each standard to identify which areas would pose the most significant challenges during implementation. Moreover, the CVCA decided in December 2004 that El Salvador would apply the 2003 version of IFRS, which is quite different than the new version issued in March 2004. The accounting standards applied will therefore not be referred to as IFRS but and Financial Reporting Standards Adopted in El Salvador ("NIF/ES").

(f) Presently, the overwhelming majority of licensed auditors do not know the standards well enough to be able to ensure they are applied by the companies they audit. Moreover, it appears that companies have not made much effort to prepare for applying IFRS.

(g) The ROSC review of a sample of audited financial statements noted a number of differences from IFRS that were not mentioned in the audit reports. This tends to corroborate the view expressed by knowledgeable persons interviewed as part of this ROSC that the current level of compliance with accounting standards is inadequate. It also points to the need to strengthen the audit practice.

AUDITOR REGISTRATION AND REGULATION – PROFESSIONAL STANDARDS

(h) Accounting and auditing is a reserved activity. There are approximately 3,300 accountants licensed to provide accounting services and perform statutory audits. The main requirement for obtaining a license of public accountants (and therefore of auditor) is a bachelor degree (*licenciatura*) in accounting from any Salvadoran university. No minimum standard has been set for the content of universities' accounting curricula. Neither a professional examination, nor practical experience is required. This departs from international good practice as codified in IFAC's education standards, and is insufficient to ensure that licensed practitioners have adequate technical knowledge and professional competence to perform quality audits.

(i) The CVCA does not monitor auditors' compliance with International Standards on Auditing. An attempt was made in 2004 to conduct some form of quality control over the audit practice in El Salvador. The CVCA has plans to introduce periodic quality control but no process has been defined for achieving that objective.

(j) The CVCA does not have the necessary resources (staff, facility, funds) to discharge its functions. At present the CVCA depends almost exclusively on budgetary allocation from the Ministry of Economy. Also, there is no full time, executive level position within the CVCA.

(k) The CVCA has established a continuing professional development obligation; however, this obligation is not adequately monitored and sanctions for non-compliance are relatively mild.

(l) The three Superintendencies within the financial system (SSF, SP and SV) have their own criteria for licensing. They monitor external auditors without coordination with the CVCA. This represents potential duplication of efforts and inconsistencies in the way auditors are regulated.

(m) There is no official code of ethics for the accounting profession at the moment. Such a code is important to ensure that practitioners adhere fully to the fundamental principles of professional conduct including integrity, objectivity, competence and—in the case of auditors—independence.

ENFORCEMENT OF THE STANDARDS

(n) The three financial sector Superintendencies are responsible for enforcing accounting standards and financial reporting requirements; however they do not have a specific department dedicated to this activity with specific expertise in international standards.

(o) The SOM is not equipped with sufficient resources to monitor non-listed companies and its scope of intervention—which includes possibly up to 50,000 enterprises—is too vast to allow it to fulfill this responsibility effectively. Moreover, its sanctioning powers are limited.

(p) In the accounting and audit profession, there are no mechanisms in place to monitor auditors' compliance with their professional obligations. As noted above, the CVCA is considering introducing a quality assurance system.

49. **On the whole, over the last five years, El Salvador has taken commendable steps to adapt its legal framework to international standards, in order to improve its accounting and auditing practice. Yet so far these efforts have had limited effect due to two main issues:**

i. ***Capacity of the local profession and businesses*** – Using international standards implies a higher level of technical knowledge, involvement of business managers in the financial reporting process, use of information technology, etc. In the case of El Salvador, efforts to increase the capacity of accountants and auditors have been limited to this date.

ii. ***Large enterprises v. SMEs*** – whereas the accounting and auditing obligations set in the law are generally adequate for the larger enterprises, they appear to place an excessive burden on smaller entities. For smaller enterprises, the burden of public accountability should be commensurate with their economic weight and social impact. For instance, imposing an external audit from a small-to-medium-sized enterprise represents a relatively high cost which is not necessarily justified by external stakeholders' information needs. Good international practice is therefore not to require audited financial statement from SMEs.

These two issues are inter-related: (a) the fact that the SOM supervises a very large population of enterprises implies a heavy burden of routine work (mainly processing corporate filings); and (b) the burden imposed by this administrative requirement prevents SOM from dedicating sufficient resources to developing the technical expertise required to properly monitor companies' financial reporting obligations.

50. **The main objective of this ROSC assessment is to assist the Government in its efforts to strengthen accounting and auditing practices and enhance financial transparency in the corporate sector.** The main development objectives these efforts address are (a) fostering growth and accountability in the private sector, (b) ensuring adequate market regulation, both in the financial sector and with respect to the provision of essential services, and (c) making the business environment more attractive for FDI. The overarching finding of this report is that, while some salutary steps have been taken, El Salvador is far from having in place the accounting and auditing systems and practices to enable attainment of the aforementioned objectives.

B. Recommendations

51. The recommendations that follow will be discussed with in-country stakeholders at a workshop to be organized in San Salvador. Inputs from the stakeholders will be incorporated into a country action plan that will be developed under the supervision of the Government of El Salvador, with the assistance of the World Bank and other donors including the Multilateral Investment Fund (MIF).[43]

52. **Addressing existing weaknesses in private sector accounting and auditing practices so that Salvadoran companies provide accurate and reliable financial information, will require amending key legislations such as the Code of Commerce and the Accounting Law of 2000.** Adapting accounting and auditing requirements in El Salvador to the country's current needs involves several actions that could not be implemented without explicit legal backing, which does not exist at present. The proposed changes to the Code of Commerce and the Accounting Law could be carried through one legislative action

53. **Remove the obligation for SMEs to have their financial statements audited.** One of the ways to achieve that, although not in an immediate and direct manner, would be to exempt small-sized *limitadas* from the obligation of having an external audit (as is common practice in many jurisdictions). Such a move would contribute to the authorities' efforts to reduce the cost of doing business in El Salvador. Another option could be to allow SAs below a certain size to opt

[43] The MIF is a multi-donor trust fund managed by the Inter-American Development Bank (IDB).

out of the audit obligation, provided shareholders unanimously agree. The criteria to determine which company would be subject to a simplified accounting and auditing regime (sales, total assets, number of employees, etc.) and the corresponding thresholds should be agreed to by in-country stakeholders, as part of the implementation stage.

54. **Put in place a detailed transition plan for the implementation of IFRS in the enterprise sector; this could entail allowing an additional two-to-three years before the effective application of IFRS by non-listed enterprises.** In the short term, considering that (a) few stakeholders are presently ready to use IFRS, (b) the development and implementation of the necessary training and material needed for a proper application of the standards will require a significant time and (c) international experience in industrialized countries (e.g., EU countries, Australia and New Zealand) shows that switching over to IFRS requires an intense and sustained effort on the part of companies and auditors, it would be prudent for the CVCA to defer to 2007 (or possibly 2008) the requirement for non-listed companies to apply IFRS. In the mean time, the CVCA should develop a comprehensive program of compulsory training for all licensed auditors (see Para. 59 below).

55. **The CVCA should adopt the most current issue of IFRS instead of the 2003 version.** The ROSC team recognizes the CVCA's concern relating to repeated changes in the IFRS standards. However, the magnitude of the changes made in 2003 and 2004 was clearly unusual and related to an exceptional event which was the adoption of IFRS by the EU. Changes will continue to occur in the future, but at a slower pace, and countries should be able to cope with these changes provided adequate mechanisms are in place for the review, and dissemination of the standards. Also, if the country is to take three years phasing in the changes from a very low current base, they may as well start from the most current version.

56. **Moreover, El Salvador should seek to enter into cooperative arrangements with other Latin American countries that have adopted IFRS.** This would help share the burden of reviewing draft IFRS standards (or revised IAS standards), as well as adopting, updating and applying these standards. Peru would seem to be a particularly appropriate partner in that regard since that country went through the process of adopting IFRS from 1994 to 1998. Two CAFTA partners, Costa Rica and the Dominican Republic have also adopted IFRS, and so has Panama. These countries and El Salvador could join their efforts in providing comments to the IASB on the exposure drafts issued to be by that institution; this would give a greater say to Latin American countries in the international standard-setting process. Other joint projects could include developing application guidance and an instruction manual in Spanish. Cooperation could bring similar benefits on professional standards (ISA, code of ethics).

57. **In the medium term, the CVCA should adopt a process of reviewing each new or revised IAS/IFRS standard before it becomes applicable.** Such a review would include (a) analyzing each new standard or revision of an existing standard (and similarly for official interpretations) to determine its main technical difficulties, (b) assessing the impact of such standard or interpretation including by conducting surveys of companies and (c) identifying the training needs to allow a proper application of the standard by the profession.

58. **The public should be given access to IFRS-based financial statements of large non-listed companies with public interest characteristics.** The criteria for determining which entities would be subject of that obligation should include: the amount of revenues, total assets and number of employees. Financial transparency in the corporate sector would receive a

significant boost if the financial statements (in full, i.e. not just the balance sheet) of the largest non-listed enterprises were prepared on the basis of IFRS and made available to third parties.[44]

59. **The CVCA should develop a training plan for accountants, both in public practice and in companies.** A pre-requisite for implementing IFRS on a large scale in El Salvador's private sector is improving the knowledge of the standards on the part of preparers and auditors so that they can use them properly. University professors who are not registered with the CVCA should also be invited to participate in this training program, to improve their ability to teach future accountants.

60. **Update the newly adopted CEPCP to reflect the 2005 current version of IFAC's code of ethics and ensure its adequate dissemination**. Developing a code of ethics that is different from IFAC's code implies not only additional costs, but it may also risk compromising the perceived credibility of El Salvador's auditing profession on an international level. Furthermore, the CEPCP requires several improvements in its scope, procedures, sanction regime and the processes associated with inspections carried out by the CVCA. Dissemination events for the new code will require the attendance of all the professionals registered with the CVCA. It will also be necessary to coordinate the mandatory incorporation of the new code into the academic curricula of all the accounting schools within the country's universities.

61. **Strengthen the licensing requirements for public accountants and auditors by establishing a certification system.** Mexico has adopted this notion in 2000, in the context of the NAFTA agreement. This has increased the credibility of the audit profession and makes it possible for national practitioners to conduct business in the US and Canada. Another country, Chile, is currently implementing the concept of *certified* public accountant. This would be an important move to strengthen the reputation of the Salvadoran accounting profession, both domestically and abroad. A professional examination is one of the cornerstones of a certification system in any country. Such system should also include as a pre-requisite three years of professional experience in accounting and auditing and an adequate academic background in those fields. IFAC's International Education Standards (IES) 1 to 6 should be used as benchmarks for developing such system in El Salvador.

62. **Establish a quality assurance system to which all registered public accountants will be subject.** The system of quality assurance should reflect the following principles and practical suggestions:

- ***Scope and conduct of the review*** – The quality assurance should be based on periodic reviews of accounting firms with a strong focus on auditing. The reviews, which are not self-reviews, should be formalized and consist in (i) analyzing and discussing the reports and working papers relating to actual financial statement audits, and (ii) assessing audit firms' and sole practitioners' policies with respect to independence, quality of audit work and continuing professional development.
- ***Process for selecting reviewers*** – Reviews should be carried out by qualified and reputable individuals, selected on a basis of objective criteria. Restricting the selection to non-practitioners would probably be unrealistic in El Salvador.

[44] In their comments to this ROSC, the Salvadoran Authorities have acknowledged the potential benefits of requiring the publication of financial statements, but expressed concerns that it could conflict with legal provisions on intellectual property. It should be noted that numerous countries including, in Latin America, Brazil (for joint-stock companies), Colombia and Uruguay, currently require non-listed companies to make their financial statements publicly available.

- ***Adequate resources and funding*** –A special commission should be established within the CVCA specifically to monitor the quality assurance program in all relevant areas including budget, selecting reviewers, and ensuring that auditors are properly included in the program.
- ***Outcome of the review process*** – The reviews should give rise to a formal report by reviewers, the findings of which should be discussed before a reviewing panel. An adequate sanctioning regime should be in place and effectively applied. Moreover, the CVCA should report annually to the public on the main issues arising from reviews and to enhance the public's confidence in the audit process as a whole.

Implementing quality assurance would serve as a deterrent against non-compliance. It would give a significant boost to the profession's credibility and would provide a useful tool to identify (i) actual difficulties in the application of standards and (ii) the required guidance and training.

63. **Require all registered public accountants to pay a membership fee to the CVCA.** A system of professional oversight as the one El Salvador has sought to establish cannot function without adequate resources, which include information technology, a permanent staff and funds to compensate practitioners who assist the oversight board in fulfilling its functions. Moreover, the oversight system is intended to benefit the members of the profession by fostering a practice of quality and providing guidance on the application of accounting and auditing standards. Accordingly, it is only natural that registered members should contribute to funding such system.[45]

64. **Harmonize audit regulation in the financial sector, in terms of registration requirements, independence and required audit procedures.** For instance, audit team rotation rules should be the same for all auditors in the financial sector. This will help reduce the administrative costs incurred by both the regulators and the audit firms and free up their resources and time to added value activities.

65. **Establish enforcement guidelines for the Superintendency of Corporate Obligations (SOM), and increase its institutional capacity to carry out its supervisory functions.** In order to make the best use of its resources, the SOM should develop a risk-based strategy for supervising companies, taking into account the type of sectors, the economic size and the track record of companies in terms of their compliance with corporate obligations. A set of written guidelines and a supervision manual should also be defined. The information system used by the SOM should be upgraded to allow the screening of companies that do not comply.

66. **Given the critical importance of related-party transactions within corporate financial disclosures, better transparency regarding stock ownership and positions of company director held by individuals is needed..** This issue should be addressed as part of a broader effort aimed at improving corporate governance and the legal regime of financial conglomerates in El Salvador.

[45] A decision would need to be taken as part of the development of the country action plan as to whether: (a) only practicing accountants (i.e. public accountants or accountants in business or working for the public sector) should be registered with CVCA, or (b) a separate chapter should be created for accountants in public practice, who would be required to pay higher fees.

67. **The recommendations of this ROSC seek to benefit the Salvadoran society as a whole by bringing more financial transparency in the corporate sector.** Specifically, the following in-country stakeholders are expected to draw benefits from the implementation of these recommendations:

- ***Salvadoran enterprises*** – Increasing investors' access to accurate financial statements and their confidence in the reliability of those statements will ultimately increase the availability of capital from investors and lenders, both domestic and international; it will also help reduce the cost of financing for Salvadoran enterprises;
- ***Salvadoran investors*** **–** Adhering to international standards and enhancing the availability of financial information (including audits) is a prerequisite for the expansion of the securities market in El Salvador, where listing and trading are currently very limited. Better financial information shared more broadly will also facilitate the development of private equity funds. A broader and deeper stock market and the availability of private equity will offer more investment opportunities to domestic investors;
- ***The banking sector*** –Making enterprises' financial statements available will allow banks to carry-out comparative analysis of financial data within the same sector. Moreover, financial information of better quality and increased reliability will facilitate the banks' lending activities and help them decrease their exposure to credit risk;
- ***The public sector*** **–** Reinforcing accounting and auditing practices in the corporate sector would support the Government's efforts to curtail corporate tax evasion in the country;
- ***El Salvador's accounting profession*** – Introducing adequate licensing requirements and quality assurance and taking vigorous actions to enhance technical competence in the accounting profession will elevate the confidence that investors and corporate entities place in the profession. This will lead to an increased recognition and perceived value of services rendered by Salvadoran professionals which in turn will facilitate an increase in revenues for these professionals. From an international perspective, this will also enable Salvadoran accountants to compete within the CAFTA area and beyond;
- ***Employees of the private and state-owned sectors***, who have an important stake in their company's success, and are therefore entitled to receive complete and accurate financial information;
- ***Retirees*** – Among local investors, pension funds would be among the main beneficiaries of a more reliable financial reporting by listed companies and of the broadening of the stock market, allowing them to diversify their investment and therefore their risk; in turn, better diversification of pension plans' assets would help safeguard the interests of retiree participating to these pension plans.

68. **Implementing the above recommendations will likely require technical assistance,** on various aspects including: (a) drafting new legislation or amendments to existing acts and regulations; (b) increasing the CVCA's, SOM's and other regulatory agencies institutional capacity to conduct their standard-setting, monitoring and oversight functions; (c) developing training material on IFRS and ISA; (d) establishing mechanisms to give the public access to public-interest entities' financial statements and (e) addressing related recruitment and training aspects. The aforementioned Country Action Plan (Para.51) will help define the scope, estimated costs and funding mechanisms for such technical assistance and related training. With respect to World Bank support, the ROSC team will assist the Salvadoran authorities in seeking international funding from specific entities designed to support the types of reforms contemplated

in this report, such as Consulting Trust Funds, the Financial Sector Reform and Strengthening ("FIRST") Initiative, the MIF, etc.