

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

ACCOUNTING AND AUDITING

January, 2007

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Executive Summary

This report provides an assessment of accounting, financial reporting and auditing requirements and practices within the enterprise and financial sectors in Georgia. The report uses International Financial Reporting Standards (IFRS), International Standards on Auditing (ISA) and draws on international experience and good practices in the field of accounting and audit regulation, including in European Union (EU) Member States, to assess the quality of financial information and make policy recommendations.

Georgia has a population of 4.5 million and gross domestic product (GDP) per capita of US\$1,415 as of 2005. Georgia's private enterprise sector is growing and the Government is pursuing an ongoing program of privatization.

The financial sector in Georgia is growing rapidly but remains largely underdeveloped, partly due to the lack of funding from local deposits and limited access to funding from foreign financial institutions. At the end of 2006, there were 18 commercial banks (one in the process of liquidation) including two branches of foreign banks operating in Georgia. The role of the insurance sector is limited but growing. There are 14 insurance companies; the seven leading companies account for 90% of the market and are owned by five different groups, with a trend toward ownership of these companies by Georgia-based banks. Given the importance of the financial sector to the development of a market economy, this report has a particular focus on the banking and insurance sectors in addition to the general corporate environment.

Georgia led the global top 10 reformer rankings on the ease of doing business in 2005–2006, according to a report by the World Bank and the International Finance Corporation (IFC). Georgia improved in six of the 10 areas studied by the 'Doing Business' report.

Accounting and Audit Reform in Georgia

Accounting and audit in Georgia are governed by a number of different laws. An initiative by the Government in 2005 was aimed at reducing restrictions on trade through removing onerous regulatory requirements; this initiative had a positive effect on auditing by removing the universal

This report was prepared by a team from the World Bank on the basis of the findings from a diagnostic review carried out in Georgia in February 2006. The staff team was led by Frédéric Gielen (ECSPS) and comprised Galina Alagardova (International Finance Corporation), Leo Asmanis (Bank of Latvia), Jon Hooper (Professional Oversight Board for Accountancy, Financial Reporting Council, United Kingdom), Georg Lanfermann (Chamber of Public Accountants, Germany), Georgine Ann-Marie Newman-Alawode (ECSPS), John O'Donnell (Financial Regulator, Ireland), and Arman Vatyan (ECSPS). The review was conducted through a participatory process involving various stakeholders and led by the country authorities.

audit requirement, which had become a potential source of corruption. The Government has proposed a new draft Law on Accounting and Audit (the ‘draft Law’) which aims to establish a consistent legal framework for accounting and audit; all references to the draft Law in this report are to the draft proposed by the Office of the State Minister of Georgia on Coordination of Reforms. This ROSC report makes recommendations to aid this process in the light of international experience and good practice, and local circumstances.

This report focuses on the principal reason for continuing with further reforms; specifically, on the benefits that the proposed reforms will bring to Georgia and its citizens. In this context, this report sketches policy recommendations to enhance the quality of corporate financial reporting and foster a financial reporting platform conducive to sustainable private and financial sector growth, thus increasing access to global financial markets and other tools of a market economy. The diagram immediately following this executive summary (Figure 1) sets out the main policy recommendations in a linear timeframe, with the critical success factors clearly highlighted.

These recommendations should be implemented as soon as possible following the publication of this report; such implementation should be led by relevant institutions in Georgia and will require the cooperation of a wide range of stakeholder groups including the Government, regulators and the accountancy profession. This process will require a senior Government figure to champion the necessary reforms and ensure implementation.

The Statutory Framework

Georgia’s current statutory framework contains inconsistencies. Joint-stock companies and certain other designated companies are required to use IFRS and to publish their audited financial statements. Other companies are required to use reduced ‘temporary accounting standards’ based on IFRS. However, there is no effective enforcement mechanism for the implementation of the standards; where regulators have enforcement powers they do not have adequate capacity to apply them effectively. Audit firms are required to apply ISA but there is currently no quality control or registration of auditors. The proposed draft Law on Accounting and Audit addresses some, but not all, of these issues. This report recommends that the Law:

- Defines those companies currently required to use IFRS as *public interest entities (PIEs)*. The current Law and proposed draft Law require that banks, other financial institutions, insurance companies and other listed entities have a mandatory audit and use IFRS; these entities are considered PIEs as in comparable legislation in many other countries.
- Requires entities to have their financial statements audited where there is a public interest in such an audit i.e. where the public has an interest in a company’s financial statements being independently verified. Such companies will typically be PIEs and will include banks, listed companies etc. The number of audits required should not exceed the capacity of the audit profession in Georgia to provide ISA-compliant quality audit services. This protects the public interest through the safeguard provided by a quality audit and increases potential investment in and by Georgian companies.
- Requires that auditors and audit firms be registered with a professional organization that is a full member of IFAC, subject to detailed requirements including compliance with ISA and other regulatory requirements, qualification criteria and submission to quality control monitoring by the registering organization. Such a registration and monitoring requirement is key to establishing and maintaining audit quality. The draft Law allows for this through the requirement that auditors be registered with a professional organization that is a full member of IFAC and the requirement that the professional organization monitors the quality of auditors’ compliance with standards. The activities of the

professional organization in registering auditors should be subject to independent oversight; this could be through a non-governmental, non-parliamentary body.

- Requires PIEs to make their audited financial statements publicly available in a timely manner, which increases transparency and investment potential.

Accounting Standards

There are some issues relating to a ‘standards gap,’ where the Georgian-language IFRS differ from the latest extant IFRS due to time-lags in translation and where regulatory requirements in the financial sector conflict with IFRS. There has also been a standards gap due to the lag between the issuance of IFRS and its adoption as a normative act in Georgian Law. This second gap is resolved by the draft Law by requiring application of IFRS and ISA as a whole, including updates as they are issued, without requiring each individual standard to be separately adopted.

However, the ‘compliance gap’ is a much greater problem, with IFRS compliance generally low, especially outside of the banking sector. A similar compliance gap is found in companies that apply ‘temporary accounting standards.’ This compliance gap is a very serious issue which materially affects the quality and usefulness of financial statements in Georgia; in some cases the non-compliance renders financial statements useless or, worse, misleading. The compliance gap was often attributable to many companies’ lack of basic understanding of IFRS fundamentals such as the accruals concept and separate financial and tax accounting, which was evident in many cases. This compliance gap renders many companies’ financial statements useless and hinders investment and loan decisions. Accordingly, this report recommends:

- Priority measures to address the compliance gap in financial statements preparation including improving the education and training of preparers of financial statements such as ‘chief accountants.’
- Enhancement of the translation process for IFRS to give a sustainable process whereby the official translation is readily and promptly available across Georgia.
- Revisiting the relationship between IFRS and prudential and other regulatory reporting requirements for the financial sector.

Auditing Standards

The ‘standards gap’ in auditing standards is small and is chiefly due to time-lags in the translation process, since Georgia requires the use of ISA for statutory audits; as with IFRS, the draft law will address this timing issue. However there is a significant ‘compliance gap’; compliance with ISA is low outside of the leading audit firms. This compliance gap in some cases renders statutory audit useless as public or investor’s safeguard of quality for financial statements. As with accounting standards, this is more due to a lack of understanding of how to apply the standards than lack of willingness. Accordingly, this report recommends:

- The development of an ISA compliant standard audit methodology and audit manual in Georgian to be readily available to auditors. This should be backed by the availability of suitable relevant training courses in implementing ISA and the standard methodology.
- Enhancement of the translation process for ISA to give a sustainable process whereby the official translation is readily and promptly available across Georgia.

Monitoring and Enforcement

Whilst various regulators such as the National Bank of Georgia (NBG), the National Securities Commission of Georgia (NSC), the State Insurance Supervision Service of Georgia (SISSG) and the Audit Council have the authority to monitor the preparation of financial statements and the

audit thereof, none have adequate capacity to do so effectively. Some of the regulators, in particular the NSC, lack adequate capacity (human resources, training etc.) to enforce compliance. The current process is limited to quick scans of financial statements and audit opinions by the regulatory authorities. This allows regulated companies to produce poor and unreliable financial information, which fails the public interest and restricts investment and development. Accordingly, this report recommends:

- That regulators, including the NBG, NSC and SISSG, increase their resources for reviewing financial statements of regulated entities and enforcing specific regulations in both capacity and expertise. As a minimum, any qualified audit opinion on the financial statements of a regulated entity should lead to an investigation by the relevant regulator, which would ensure that companies apply proper resource to producing unqualified financial statements.
- That all auditors be subject to a system of external quality assurance monitoring, The results of the monitoring should be instrumental in auditors retaining their registration for audit, which could be issued subject to restrictions or conditions as a result of poor quality work. This would directly improve audit quality.
- That an effective system of investigation and disciplinary sanctions be established for auditors to identify and exclude persons not capable of auditing.
- That, following the enactment of the draft Law, regulators review regulations to amend any regulations that are inconsistent with the new Law.

The Accounting and Auditing Profession

The accounting and auditing profession in Georgia is represented by a dominant professional organization, the Georgian Federation of Professional Accountants and Auditors (GFPAA), with over 2,000 members. However, some estimates indicate that this represents only roughly 10% of the accountants in Georgia, with many of those non-members being ‘chief accountants,’ the main accounting role in the previous regime. Of the GFPAA membership, roughly a quarter are qualified ‘full’ members, with the remainder unqualified associate members.

Approximately 580 individuals held the now-defunct audit qualification previously issued or recognized by the Audit Council. The proposed draft Law on Accounting and Audit requires auditors to be a professional accountant who is a member of professional organization that is itself a full member of the International Federation of Accountants (IFAC). It also states that the professional organization is responsible for registration of accountants. Accordingly, this report recommends:

- That the draft Law requires that professional organizations register auditors in accordance with IFAC guidelines; one such guideline would require that auditors hold a professional qualification compliant with relevant IFAC International Education Standards combining appropriate examinations and practical experience requirements. Professional organizations should also have procedures to recognize suitable foreign qualifications, subject to a test of relevant Georgian law and regulations. This will enable investors and banks to place trust in the audit process as they will know the audit is performed by suitably qualified persons.
- The establishment of a publicly-available electronic list of certified auditors and audit firms. Under the draft Law, this would be held by the professional organization(s).
- That the GFPAA continues its role in leading the Georgian accounting profession. It should seek to include within its membership all interested and qualified Georgian accountants and make training and qualifications available and accessible to update its

members' skills and knowledge, thus addressing the 'compliance gap' noted above.

Education and Training

The GFPAA is the main provider of accountancy training in Georgia, though accountancy is also taught as part of economics and other university degrees and as part of MBA programs. The GFPAA offers a Georgian language qualification based on translations of the U.K. Association of Chartered Certified Accountants (ACCA) 2001 syllabus; however, this qualification can take up to seven years to complete. As mentioned above, the key challenge in education and training of accountants in Georgia is improving the skills level and knowledge of preparers of financial statements in Georgia. Accordingly, this report recommends:

- Measures to encourage preparers of financial statements in Georgia to improve their accounting knowledge. Demand side measures could include incentives for retraining and enforcement of directors' responsibility for financial statements. Supply side measures could include incentives for private sector provision of accountancy training specifically tailored to the needs of Georgian companies.
- That the GFPAA establish a recognized qualification at a lower level than its full qualification, which would be affordable and accessible to accountants in industry and to which such accountants could aspire.
- That the GFPAA work to bring the quality of its Georgian language ACCA-based qualification up to the standard of the English language ACCA qualification through improvements to its exam setting process.
- That the GFPAA work closely with Georgian universities to coordinate syllabuses such that some exemptions could be granted for some of its first level examinations for relevant study.
- That key operational staff from regulators such as the NBG, NSC and SISSG are seconded to similar agencies abroad for 'on the job' training.

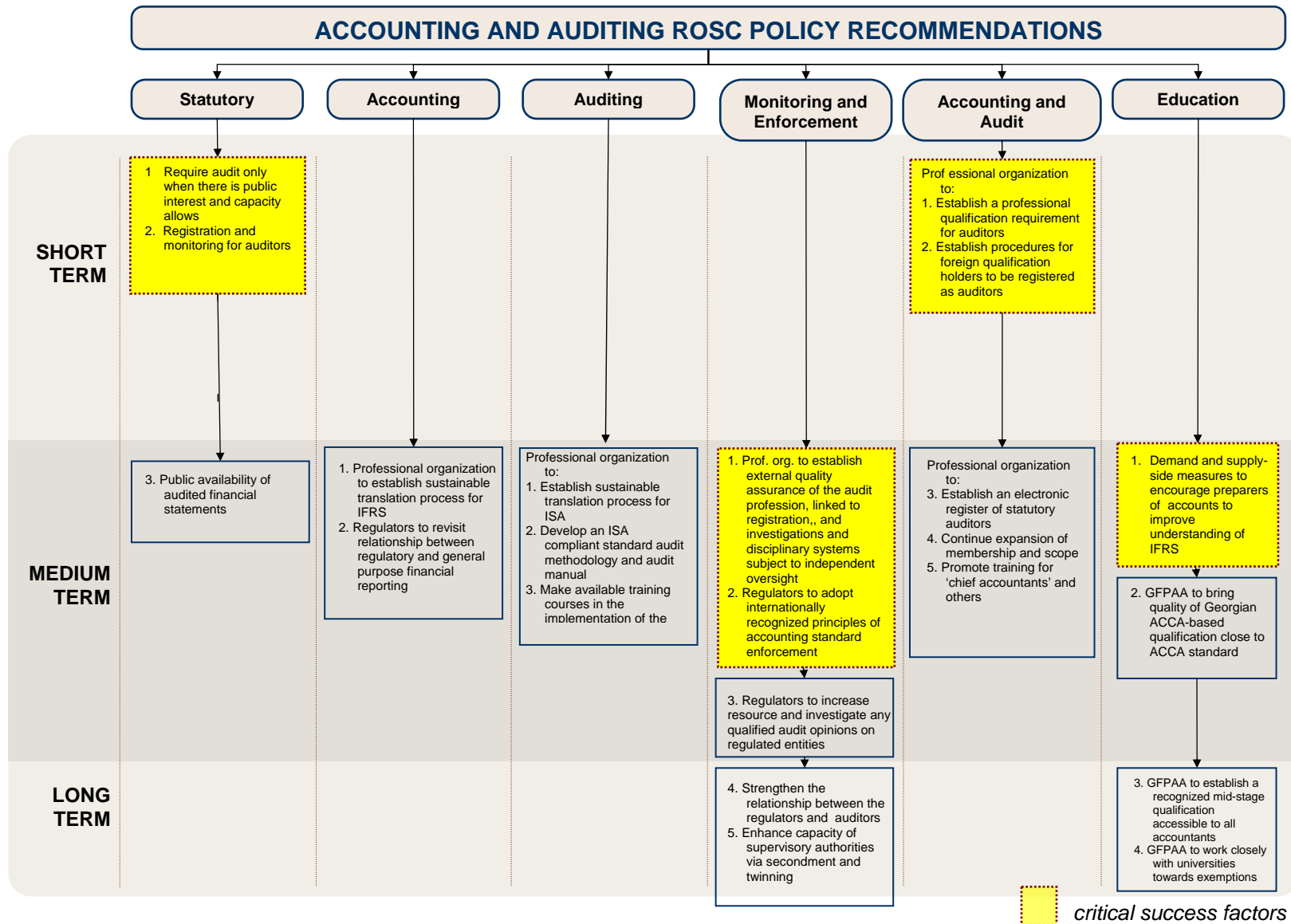


Figure 1: Main Policy Recommendations in a Linear Timeframe

MAIN ABBREVIATIONS AND ACRONYMS

ACCA	Association of Chartered Certified Accountants
CPD	Continuing Professional Development
EU	European Union
GDP	Gross Domestic Product
GFPAA	Georgian Federation of Professional Accountants and Auditors
IAASB	International Auditing and Assurance Standards Board
IAESB	International Accounting Education Standards Board
IAIS	International Association of Insurance Supervisors
IAPS	International Auditing Practice Statement
IAS	International Accounting Standards
IASC	International Accounting Standards Committee
IASCF	International Accounting Standards Committee Foundation
IES	International Education Standard
IESBA	International Ethics Standards Board for Accountants
IFAC	International Federation of Accountants
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IPA	Institute for Professional Accountants
ISA	International Standards on Auditing
JSC	Joint Stock Company
LLC	Limited liability company
NBG	National Bank of Georgia
NSC	National Securities Commission of Georgia
PIE	Public Interest Entity
PPE	Property Plant and Equipment
ROSC	Reports on the Observance and Standards of Codes
SISSG	State Insurance Supervision Service of Georgia
SME	Small and Medium-Sized Enterprises
SMO	Statement of Membership Obligations
SOE	State Owned Enterprise
USAID	United States Agency for International Development

I. INTRODUCTION

1. This assessment of accounting and auditing practices in Georgia is part of a joint initiative of the World Bank and International Monetary Fund (IMF) to prepare Reports on the Observance of Standards and Codes (ROSC). The assessment focuses on the strengths and weaknesses of the accounting and auditing environment that influence the quality of corporate financial reporting and involves a review of both mandatory requirements and actual practice. The report specifically addresses financial reporting in the banking and insurance sectors, reflecting the high level of public interest in these sectors. It uses International Financial Reporting Standards (IFRS)¹ and International Standards on Auditing (ISA)² as benchmarks and draws on international experience and good practice in the field of accounting and auditing regulation.
2. Georgia has a population of 4.5 million and gross domestic income (GDP) per capita of US\$1,415 as of 2005. Georgia's private enterprise sector is growing and the Government is pursuing an ongoing program of privatization.
3. At the end of 2006, there were 18 licensed commercial banks operating in Georgia, including two branches of foreign banks from Azerbaijan and Turkey. The six largest banks control more than 85 percent of the total assets, loans and deposits, with the largest two banks controlling 40 percent of assets and 46 percent of system deposits. Foreign entities play a significant ownership role in the Georgian banking sector. Besides the two foreign bank branches, foreign investors maintain shares in 12 banks and account for almost half of the authorized capital. Two of the largest six banks have majority foreign ownership. In addition, international financial institutions (IFIs) have significant shares in a number of banks.
4. Growth in commercial bank credit to the private sector increased dramatically in 2005, with the number of loans growing by 34 percent and the total value by 83 percent. Total private sector credit rose from 9.5 percent of Gross Domestic Product (GDP) in 2004 to 15 percent in 2005.
5. The role of the insurance sector is limited but is growing. While there has been significant recent market growth, the premiums in 2004 were only GEL 45.1 million (circa US\$ 25 million), representing approximately 0.3% of GDP.³ There are 14 insurance companies; the seven leading companies account for 90% of the market. These seven companies are owned by five different groups, with a trend toward ownership of these companies by Georgia-based banks. Expertise in relation to underwriting, claims measurement and insurance accounting is limited and is confined to a small group of individuals. Life assurance and pensions are also sold through insurance companies in Georgia, though these markets are in their infancy.
6. This report focuses on the principal reason for continuing with further reforms, specifically, on the benefits that the proposed reforms will bring to Georgia and its citizens. In

¹ International Financial Reporting Standards are issued by the International Accounting Standards Board (IASB), an independent accounting standard-setter based in London, United Kingdom. The IASB announced in April 2001 that its accounting standards would be designated 'International Financial Reporting Standards' (IFRS). Also in April 2001, the IASB announced that it would adopt all of the International Accounting Standards (IAS) issued by the International Accounting Standards Committee (IASC). For simplicity's sake the term IFRS will mean both IFRS and IAS in this report.

² International Standards on Auditing are the standards issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants (IFAC).

³ As compared with the European Union where insurance is over 8% of GDP, for example.

this context, this report sketches policy recommendations to enhance the quality of corporate financial reporting and foster a financial reporting platform conducive to sustainable private and financial sector growth, thus increasing access to global financial markets and other tools of market economy.

II. INSTITUTIONAL FRAMEWORK⁴

A. Statutory framework

A.1. Framework for Accounting and Financial Reporting

7. **There are six main types of commercial enterprises outlined in the Law on Entrepreneurs.** The focus of this report is on the two primary types of commercial enterprises where shareholders have limited liability, that is, *limited liability companies* (LLCs) and *joint stock companies* (JSCs):

- The *limited liability companies* (LLC), the shares of which are not publicly tradable, have a minimum capital of GEL 200 (circa US\$ 110). Limited liability companies generally have a small number of shareholders and have a management board composed of one or more members (there is no separation of ownership and control in most LLCs). However, the articles of association may provide for the establishment of a supervisory board; one is required in certain circumstances.
- The *joint stock companies* (JSC), the shares of which may be publicly tradable, have a minimum capital of GEL 15,000 (circa US\$ 8,400). Joint stock companies generally have a large number of shareholders, a management board, and a supervisory board. At the end of 2005, there were approximately 1,800 joint stock companies registered in Georgia. Any enterprise, except a cooperative, with more than 50 partners or shareholders must be established as a JSC.

The Law sets out that all enterprises shall be registered with the local tax authorities.

8. **The Law on Entrepreneurs states that members of the board of directors are collectively responsible for the probity of financial statements but it remains ambiguous and largely untested.** The Law on Entrepreneurs sets out that ‘managers’, i.e. the directors (management board) in an LLC or a JSC, are jointly responsible for compliance with legal accounting requirements. However, the Law does not set out whether (a) the management and supervisory boards are collectively responsible, (b) the directors are liable to the company and third parties, and (c) whether the scope of responsibility applies to the legal entity and consolidated financial statements. This matter of directors’ responsibilities falls outside of the scope of the draft Law on Accounting and Audit.

9. **In line with what is currently prevailing in a lot of countries around the world, including European Union (EU) Member States, shareholders are required to approve the financial statements of a company.** The Law on Entrepreneurs requires that the meeting of shareholders approves the financial statements of the company and the distribution of profits within 2 months of the date of compiling of the balance sheet. However, it is not clear whether parent company shareholders are also required to approve consolidated financial statements of a group. While shareholders of JSCs also appoint the auditor at a general meeting, the Law does not

⁴ This report outlines the legal principles applicable with regard to accounting, auditing and financial reporting and does not attempt to give anything more than an introduction to the issues. This report is not meant to be an exhaustive rendition of the law nor is it legal advice to those reading it.

include any termination mechanisms for an audit engagement, so an auditor may be dismissed or resign to avoid an audit qualification.

10. **There has been ambiguity in the legal framework as to what accounting standards actually apply in the Georgian corporate sector.** The ambiguity results from potentially conflicting requirements and lack of clarity as to what standards have legal backing:

- The Law on Entrepreneurs sets out simplified financial reporting requirements for small enterprises, defined as enterprises employing less than 20 employees with an annual turnover not exceeding GEL 500,000 (circa US\$ 279,000).
- However, the Law on the Regulation of Accounting and Financial Reporting, dated February 5, 1999, (the ‘Accounting Law’) states that ‘all legal entities, except small enterprises, are required to prepare their financial statements in conformity with International Accounting Standards (IAS) and temporary accounting standards.’⁵ The Accounting Law was supplemented in 2005 by two Regulations of the Accounting Commission at the Parliament of Georgia (the ‘Accounting Commission’) as follows:
 - Regulation No. 9, dated April 5, 2005 enacted ‘simplified (temporary) accounting standards’ for small enterprises.
 - Regulation No. 11, dated April 6, 2005 adopted IFRS issued by the International Accounting Standards Board in 2004’ as the standards applicable in Georgia.

The Accounting Law read in conjunction with the above Regulations would imply that:

- Between year 2000 and 2004/5, all enterprises, except small enterprises, were required to comply with IAS extant in 2000. Small enterprises had no specific accounting standards to abide by.
- Starting 2005/2006, all enterprises, except small enterprises are required to comply with IFRS extant in 2004. Small enterprises are allowed to use the ‘temporary accounting standards.’

The above framework has resulted in a standards gap, i.e. differences between standards required by law in Georgia and ‘full IFRS,’ since the version of IFRS which has legal backing in Georgia, is outdated as compared to full current IFRS. The impact of these differences is analyzed in Section III of this report.

11. **The proposed draft Law on Accounting and Audit clarifies the accounting and financial reporting requirements of Georgian companies.** Under the draft Law, banks, insurance companies, stock and commodity exchanges, issuers of securities and investment institutions must apply IFRS; all other private entities can apply either IFRS or national standards. There are no exemptions for ‘small enterprises’. The draft Law also requires that all companies employ an accountant (who must be ‘adequately qualified’) or the services of a competent person for accounting purposes. The draft Law requires accounting documents to be kept for six years.

12. **This report supports the two-tiered financial reporting structure proposed in the draft Law, with certain defined entities required to apply IFRS, and all other entities applying simplified financial reporting requirements.** In order to be consistent with similar requirements across the EC and in other countries, those companies required to apply IFRS should be defined as *public interest entities* (PIEs).

⁵ These ‘temporary accounting standards’ are simplified standards issued by the GFPAA based on IFRS.

13. **All JSCs are required to submit audited financial statements to the National Securities Commission (NSC).** However, of approximately 1,800 JSCs registered in Georgia only 480 companies submit audited financial statements annually. The NSC is attempting to contact the JSCs that do not file financial statements, but it has limited resources and often finds that the registered addresses of such firms either do not exist or are abandoned. Some of the 1,800 JSCs may have ceased operating, but it is likely that some large, active JSCs do not currently report. However, the NSC's efforts have resulted in the number filing increasing annually from 109 in 2000 to 294 in 2002 up to 480 in 2005. However, very few of these JSCs are actually listed companies. Large limited companies are not required to file financial statements at present. The Government has proposed a new draft Law on Securities which addresses some of the issues above.

14. **Banks are required to prepare their financial statements in accordance with 'IAS and the regulations of the NBG,' which result in conflicting requirements, falling short of 'full IFRS.'** The Law of Georgia on Activities of Commercial Banks of 1996, as last amended on October 23, 2001, (the 'Banking Law') requires banks and their subsidiaries to prepare annual financial statements in accordance with 'sound accounting practices pursuant to International Accounting Standards.' The National Bank of Georgia sets out the layout of the primary financial statements, and recognition and measurement principles. Even though the Banking Law makes direct reference to 'International Accounting Standards,' the regulations issued by the NBG have not been updated since they have been issued in 2001 and have therefore not kept pace with 'full IFRS.' Consequently, there are a number of differences with respect to recognition and measurement principles as set forth in Paragraph 64 below.

15. **The Banking Law also requires all commercial banks and branches of foreign banks operating in Georgia to have annual external audits of their financial statements.** The Law requires the audit to be carried out in accordance with the procedures established by the NBG. However, at present, the NBG has not developed such procedures for external audits, except for the requirement for banks to (i) inform the NBG about the statutory auditors they have appointed and (ii) submit to the NBG the auditors' report and the management letter.

16. **Bank financial statements are not always readily and publicly available, though, as all banks are JSCs, they should submit full financial statements to the NSC.** The NBG requires banks to publish only their balance sheet, profit and loss statement, and auditors' report.⁶ Some commercial banks make the full set of their financial statements (including all the notes to the financial statements) available on their websites and/or at their premises,

17. **Insurance undertakings are subject to the same financial reporting requirements as other companies, bar some technical provision adjustments set by the State Insurance Supervision Service of Georgia (SISSG).** These requirements differ significantly from IFRS (refer to Paragraph 65 below) and, while reasonable based on the current nature of the business, will lead to future problems if they are not enhanced as the industry develops. The ROSC team was not made aware of any requirement for public disclosure of audited financial statements specifically for insurance companies; however, insurance companies are required to submit an audited balance sheet and income statement to the SISSG each year together with other reports per the SISSG prescribed format quarterly and annually. Some of these SISSG format reports are published.

⁶ Banks are also required to publish in the official newspaper their quarterly balance sheets and profit and loss statement.

A.2. Framework for Auditing

18. **The 2005 Law on ‘the Granting of Licenses and Permits,’ which was aimed at removing bureaucratic restrictions in Georgia, removed the necessity to obtain a license to conduct statutory audits. As a result, the provision of audit services is not currently regulated; any commercial entity can provide statutory audit services.** There is no minimum qualification to provide statutory audit services in Georgia.⁷ This is a weakness in audit regulation and differs materially from most other countries (including all EU Member States), which strictly regulate statutory auditors in order to ensure a minimum level of audit quality. The proposed draft Law addresses this weakness.

19. **The June 2005 deregulation also removed the statutory requirement for audit for the majority of companies in Georgia.** This was a measure aimed at reducing corruption as the previous universal audit requirement led to a large number of very low-quality audits performed at unrealistically low prices; the requirement had become a source of corruption. Audited financial statements are currently only required by law for banks, insurance companies, and joint stock companies. This audit requirement is confirmed in the proposed draft Law on Accounting and Audit.

20. **The proposed draft Law on Accounting and Audit re-introduces a registration requirement for auditors but does not change the audit requirement for companies.** The draft Law requires the auditor to be a ‘professional accountant,’ who must be a certified member of a professional organization, which in turn is a member of the International Federation of Accountants (IFAC). The Law requires the organization to establish, evaluate and monitor the quality of audit services rendered by auditors; this should be linked to registration.

21. **The draft Law abolishes the Accounting Commission and the Audit Council and delegates their functions to professional organizations, defined in the Law as unions of accountants and/or auditors registered under Georgian legislation that are full members of IFAC. Professional organizations should administer registration of auditors and audit firms on the basis detailed in Paragraph 85.** While such delegation and self-regulation is common in other countries, it is considered best practice for any professional organization to which such important responsibilities are delegated to be subject to some independent monitoring to guard against the potential conflict of interest inherent in a body that both represents and regulates its members. Membership of IFAC will not provide this necessary control as membership is not conditional on strict compliance with IFAC guidelines; IFAC does not operate any direct monitoring system of quality control over its member bodies. This report does not dictate the best way to achieve this monitoring; however the objective is to ensure that the professional body fulfils its obligations under the delegated responsibilities in the public interest and free from corruption.

22. **There are no additional legal requirements regarding audits of banks and other credit institutions.** In general, the results of the statutory audits of banks are not used for banking supervision purposes. The National Bank of Georgia has set up its own standard review procedures in order to determine whether the financial reporting of banks is adequate. In this regard, the interaction with the statutory auditors is practically not existent, which may result into duplicative work and burdens for the banks concerned. The NBG and the audit profession could leverage the guidelines set forth jointly by the Basel Committee on Banking Supervision (BCBS)

⁷ This also means that the Audit Council of Georgia cannot sanction any misconduct of an auditor because its only sanction comprised the revocation of audit licenses.

and the International Auditing and Assurance Standards Board (IAASB) in *'The relationship between banking supervisors and banks' external auditors'*.

23. **The SISSG applies a bylaw 'Rule on Reporting by Insurance Companies,' dated February 12, 1999, which includes a requirement for an audit report to accompany the financial statements.** The SISSG has no further guidance or supervision in relation to auditors or the audit report, such as reviewing the management letter. Also, there is no apparent interaction between the SISSG and insurance company auditors. The guidelines set forth by the BCBS and the IAASB (refer to Paragraph 22 above) could also be helpful in the insurance sector.

B. The Profession

B.1. The Accounting Profession

24. **The proposed draft Law on Accounting and Audit defines an accountant as 'an adequately qualified person hired by the entity to do accounting and prepare financial statements'.** A 'Professional Accountant' is defined in the law as a person 'certified as a professional accountant by a professional organization (member of IFAC)'. While the size of the accounting profession is not easy to accurately define, observers estimate that there are approximately 20,000 accountants in Georgia, many of whom work as 'chief accountants' in industry.

25. **The Georgian Federation of Professional Accountants and Auditors (GFPAA) is the dominant professional organization in Georgia and has circa 2,000 members, 469 full members who hold its certification and another 1,550 associated members without a certification.** The full members of the GFPAA all qualified before 2001 through having passed the then entrance qualification or by having met the previous requirements for membership through experience in accounting. Since 2001, the GFPAA has set new requirements for full membership, limiting it to people who have completed a suitable entrance qualification offered by an IFAC member body or the GFPAA's accountancy qualification, which is based on the U.K. Association of Chartered Certified Accountants (ACCA) qualification translated into the Georgian language. The GFPAA currently has approximately 450 students in the process of completing the 13 exams of their 'ACCA-based Georgian-language qualification', but none have yet completed all 13 exams. Section II.C of this report provides more detail on education and training.

26. **A small number of Georgians have taken English-language qualifications of IFAC member bodies,** primarily the U.K. ACCA exams administered by the British Council in Tbilisi. Some others are studying for the English-language ACCA but they often have to go outside Georgia for appropriate teaching as it is not generally available within Georgia. It is estimated that there are less than 20 accountants in Georgia holding a foreign qualification.

27. **One of the main challenges facing the accounting profession in Georgia is educational.** While Georgia has adopted IFRS-based requirements for financial reporting (refer to Paragraph 10 above), many members of the profession struggle to understand and implement these requirements. Often bookkeeping and financial reporting are conducted according to the tax rules and financial statements are still prepared on a cash basis (commonly used before 2000) as opposed to the accrual basis required by IFRS. The quality of the accounting profession, and with it the quality of financial reporting, depends on improving the ability of all Georgian accountants to understand and apply accrual accounting and, where appropriate, IFRS.

28. **Educating ‘chief accountants’ who are in situ at Georgian companies is key to improving the practical application of IFRS and accrual accounting.** Newly qualifying accountants are generally being taught IFRS and accrual accounting at university level or through the GFPAA’s ACCA-based qualification. Their level of understanding of IFRS and accrual accounting will generally be higher than many established accountants currently holding positions in companies as accountants, financial controllers and financial directors. However, the established accountants should be given to opportunity to improve their understanding of IFRS and accrual accounting and their application to their work within the financial reporting framework in Georgia.

29. **The profession must concentrate on practical application of IFRS and accrual accounting.** The core concepts, such as the accruals basis, the separation of tax and financial statements and the interaction of financial statements, management accounting and cash flow should be central to the education of the profession.

30. **The GFPAA should attempt to represent the whole accounting profession.** Through associate membership, the GFPAA should first attempt to bring within its membership as much of the profession, that is those working as professional accountants, as possible. Alternatively, it could offer training courses across Georgia through its branch network and offer associate membership to those who complete courses. Then it should work to educate its membership through graded qualifications (refer to Section II.C of this report).

31. **The level of knowledge of many commercial banks’ and insurance companies’ accounting personnel in respect of the application of IFRS is low and there is a widespread problem in following changes in IFRS requirements (see also section III below).** At present, staff at many of the banks and insurance companies are not aware of changes in IFRS effective as of January 1, 2005.

B.2. The Audit Profession

32. **Before July 2005 approximately 580 auditors were authorized by the Audit Council at the Parliament of Georgia (the ‘Audit Council’).** Approximately 500 were authorized directly by the Audit Council and 80 were authorized under an arrangement with the GFPAA. In addition, either the auditor or their firms had to hold an audit license, which was valid for three years. As described in Paragraphs 18 to 20 above, these arrangements were abolished in July 2005; new arrangements are proposed under the new draft Law on Accounting and Audit. The draft Law contains a transitional provision requiring professional organizations registered in Georgia to provide a special accountant qualification program for persons who were previously authorized by the Audit Council. Paragraph 89 below sets out recommendations regarding a suitable qualification for auditors.

33. **Under current statutory audit requirements, only approximately 20 firms perform statutory audits.** Only banks, other JSCs and certain other specified companies are currently required to have a statutory audit; these are performed by a small number of audit firms, which includes the local member firms of international audit firm networks and a few leading local audit firms.

34. **Differences in the technical proficiency, level of experience and level of resources across the audit firms result in significant variations in audit quality (see section IV below).** The local member firms of international audit firm networks have the benefit of firm-wide internal quality control procedures, often benefiting from resource from outside Georgia. Some of

the leading independent Georgian firms have had previous experience working with international audit firm networks and retain methodology and experience from this. Finally, there are independent Georgian audit firms that have developed their own audit methodologies in accordance with the translated ISA. There is currently no external quality control monitoring of audit firms.

35. **Ethical requirements follow international standards, but are not enforceable.** A 1997 Decree sets out some general ethical requirements for auditors. In addition, the Audit Council made the translated November 2001 version of the IFAC Code of Ethics mandatory for all auditors. However, the Audit Council's ethics code has not been updated to reflect the changes made in June 2004 and 2005 by the International Ethics Standards Board for Accountants (IESBA) of IFAC, which included enhancements to the section on auditor's independence. More importantly, ethical requirements are not enforceable by the Audit Council, since there are no sanctioning possibilities.

36. **Auditor liability is not clearly regulated.** The Audit Law requires that the auditor or audit firm would have to cover the damages incurred by the auditee caused by the auditor or audit firm. However, the Law could be more specific. In practice, there are examples of attempts to contractually limit auditor liability to the fees received for the statutory audit (or a multiple). It is unclear whether such practice would stand a test in a Georgian court as there does not seem to have been any legal case where there was a dispute between auditor and an audited company.

37. **While the GFPAA is a full member of IFAC and aims to comply with IFAC Statements of Membership Obligation (SMOs),⁸ it does not yet comply with all SMOs.** Specifically, the GFPAA falls short of the SMOs in regard to SMO 1, *Quality Assurance* and SMO 6, *Investigation and Discipline*. (refer to Paragraph 88).

C. Professional Education and Training

38. **Accountancy and audit education is offered at universities, colleges and business schools in Georgia, both as part of economics or business administration degrees and as specific accounting degrees.** Such courses' curricula are based on IFRS in some, but not all, cases. Universities appear to have little difficulty recruiting students for business and economics degrees, and many such students take accountancy options.

39. **There appears to be little cooperation between the GFPAA and such education providers.** The GFPAA does not currently offer any exemptions for any of its papers of its Georgian-language qualification where subjects have been covered in sufficient depth through university study. Such exemptions are available for other qualifications such as the ACCA qualifications. The availability of such exemptions reduces the length of time required to complete the GFPAA qualification, and thus increases training capacity.

40. **The range of professional accounting education and training available currently in Georgia includes:**

- *The GFPAA has offered a Georgian-language accountancy qualification since 2000, which is based on translations of 13 course textbooks of the ACCA's 2000 syllabus.* The

⁸ IFAC SMOs are designed to provide clear benchmarks to current and potential IFAC member organizations to assist them in ensuring high quality performance by accountants worldwide. SMOs cover quality assurance, education standards, auditing standards, ethics, investigation and discipline, etc. For additional information, refer to <http://www.ifac.org/Compliance/index.php>.

translated books are subject to regular revisions to incorporate new IFRS and changes to the ACCA course. Students attend evening lectures at the GFPAA's Institute for Professional Accountants (IPA) as most are working full time. The IPA can only accept circa 150 students each year. Students can take two papers within one twice-yearly examination period prior to passing eight papers, i.e. they can pass four papers in a year; after passing 8 papers students can take three papers in one examination period. Consequently good students can complete the program within 3 years, but most take longer. The 13 exams are grouped into three stages with three papers in stage one, six at stage two and four at stage three. Completion of each stage is an important milestone. Many accountants define their degree of qualification by the paper they were studying such as 'I'm taking paper 3.2'.

The ACCA-based Georgian qualification is not accredited by the ACCA and does not lead to ACCA membership. It is not clear whether this is fully understood by the Georgian market, by all students, or by ACCA itself. English language speakers are valued highly for their language skills, so the English-language ACCA is more highly rated.

- ***Self-study towards the English-language ACCA qualification.*** The GFPAA offers to support students through the English-language ACCA, for which students must register individually with the ACCA in Glasgow. The GFPAA offer teaching for the first four ACCA papers; beyond those papers, little or no formal teaching is available in Georgia and students generally self-study. Exams are administered by the British Council in Tbilisi. Students must pass the exam and complete three years of relevant training to become ACCA members. It is estimated that up to 20 Georgians have qualified through this route.⁹ This route to qualification is unlikely to contribute large numbers to Georgia's accounting and auditing capacity.

- ***The GFPAA offers courses for accountants and auditors to facilitate their continuous professional development (CPD).*** In addition, the GFPAA offers ***other accounting courses*** to non-member, such as a training program for accountants (for beginners) and IFRS conversion training courses. It can offer these across Georgia through its six regional and four district branch offices.

41. **The range of accountancy education and training detailed above has the potential to train and develop well-qualified accountants who can lead Georgian accounting in the future.** However, there are severe capacity constraints as very few students can start professional accountancy courses each year and many drop out due to the costs and difficulty of the qualification. Georgia's accounting capacity can be more rapidly expanded by addressing the education needs of older members of the profession who are already working as accountants, and who have, in many cases, been working as accountants for many years. In addition, the different elements (university, professional qualification, CPD) also need to be better integrated (see Paragraph 90 below).

42. **Continuing Professional Development (CPD) is not currently required for auditors or accountants by the Audit Council.** However, the proposed draft Law on Accounting and Audit requires that an auditor's qualification is 'confirmed by continuous education'. The requirement for auditors to maintain their technical competence is crucial to audit quality; it is required in EU countries as part of the requirements of auditors in the 8th Directive. CPD is one of the key ways by which auditors can maintain their technical competence. In addition, IFAC-member professional bodies are required to promote and facilitate CPD as part of their

⁹ It may be possible to self-study towards other international accountancy qualifications such as the United States Certified Public Accountant qualification. The ROSC team did not note any examples of such study.

membership obligations. The GFPAA requires its full members to perform CPD each year and organizes training courses.

D. Setting Accounting and Auditing Standards

43. **There are two main processes involved in setting and translating accounting standards in Georgia, i.e. (a) the translation of IFRS, and (b) the development and adoption of ‘temporary accounting standards’ applicable to those entities not required by Georgian law to use IFRS.** Both processes are currently overseen by the Accounting Commission. At the date of this report, an official Georgian translation of 2004 IFRS is available.¹⁰

44. **The translation of ISA is currently overseen by the Audit Council.** The 1999 and 2004 versions of the IFAC Handbook of International Auditing, Assurance, and Ethics Pronouncements, which cover ISA, the International Auditing Practice Statements (IAPS), the Code of Ethics for Professional Accountants, etc. have been translated.

45. **At present, the translated standards must be adopted as normative acts before they are in force, which leads to a further lengthy delay in implementing IFRS and ISAs in addition to the translation delay.** The new draft Law on Accounting and Audit addresses this by adopting as a normative act the ISA standards as a whole, not individually, including any updates or new standards automatically.

46. **The draft Law on Accounting and Audit abolishes the Accounting Commission and Audit Council and leaves the translation process for both to the professional organizations registered in Georgia, which in the short-term will mean the GFPAA.** The process of translating the IFRS and ISA has been undertaken by the GFPAA with donor support from United States Agency for International Development (USAID). The translation is performed by individuals under contract to GFPAA, as the GFPAA does not have the capacity or expertise. The translations of each standard are reviewed by the local member firms of international audit firm networks. The reviewed standards are then edited by Georgian-language editors prior to publishing.

47. **Difficulties in obtaining expert translators with experience of English and Georgian language together with a deep understanding of accounting and auditing has led to inconsistencies and inaccuracies in the translation** especially where standards deal with issues that are uncommon in Georgia, such as ‘functional currency,’ ‘presentation currency, etc. However, the resources applied to translating IFRS and the quality of translation appear to be well in advance of the level of current understanding and usage of IFRS. The problems with regard to the practice of IFRS (see Section III) are at a much more basic level than the problems that may exist in the translation of standards. Problems with the accruals concept, the separation of tax and financial statements, format of financial statements and other such common problems are not caused by inconsistent terminology between two advanced standards relating to complex financial instruments. The major challenge facing Georgia is in education in IFRS and encouraging and enforcing implementation of the basic principles of IFRS.¹¹

¹⁰ For a discussion of the issues arising from lack of current and official translations in written law jurisdictions, refer to *Implementation of International Accounting and Auditing Standards: Lessons Learned from the World Bank’s Accounting and Auditing ROSC Program*, Hegarty, Gielen, Hirata Barros, World Bank, September 2004.

¹¹ The few companies in Georgia, such as the leading banks, which may have cause to use the complex, advanced standards where the inconsistencies or inaccuracies might occur are more likely to have staff

48. **The translation of IFRS and ISA is not an ongoing and sustained process.** The current process does not allow for ongoing translation of IFRS and ISA into the Georgian language as they are being amended. Rather, translations have been updated every five years or so. Due to lacking English language skills, most individual accountants, auditors and audit firms are not in a position to apply the latest changes.

49. **The GFPAA has developed a reduced set of accounting standards, which have been approved by the Accounting Commission and adopted by the Ministry of Justice.** These ‘temporary accounting standards’ for small companies are derived from IFRS and exclude much of the detail of IFRS that the GFPAA deemed irrelevant for small companies. The GFPAA has also developed a further reduced set of standards for use by not-profit legal enterprises. The draft Law adopts these standards for entities that are not required to have an audit.

50. **Both of these sets of reduced standards are seen as temporary in anticipation of Accounting Standards for SMEs, which are being developed by the International Accounting Standards Board (IASB).** The Accounting Commission intends to adopt the IASB SME standards once they can be translated. If and when this occurs, the setting of these standards will also be outside of Georgia and similar translation and adoption issues as detailed above will apply.

51. **The GFPAA also develops and publishes user guides in Georgian for IFRS and for both sets of temporary accounting standards.** These guides are comprehensive and are similar in length to the published translations of IFRS and suites of reduced standards.

52. **Accounting standards for banks are supplemented by regulations and instructions issued by the National Bank of Georgia.** The instructions are based on International Accounting Standards extant in 2001, which differ from ‘full IFRS’ as discussed in Paragraph 64 below. These regulations set forth measurement principles for the allowance for loan losses.

53. **Accounting standards for insurance companies are the same as those for other JSCs and LLCs and are supplemented by SISSG bylaws on the measurement of technical reserves.** As discussed in Paragraph 17 above, both accounting and auditing requirements for insurance companies are the same as those for other JSCs or LLCs. At present, the SISSG does not influence the accounting or auditing standard setting process – it should seek to influence the process where appropriate. The SISSG has the authority, through the introduction of bylaws, to positively influence the quality of financial reporting and (indirectly) of audit work.

E. Enforcing Accounting and Auditing Standards

54. **Regulatory bodies in Georgia such as the NBG, NSC, SISSG and the Audit Council currently have the authority to enforce accounting and auditing standards.** Each has the power and responsibility to review financial statements and audit work prepared by the entities each body regulates. Each has some degree of sanctions they can impose; until the removal of the license requirement even the Audit Council had the right to sue or remove the license of auditors who were not complying with legislation.

or access to experts who can resolve any confusion by reference to the original English version of IFRS. However, these inaccuracies remain an issue when it comes to the enforceability of these standards in Georgia.

55. **A lack of capacity to implement this authority at each of the regulators has resulted in very little or no effective enforcing of accounting and auditing standards.** This has contributed to the compliance gap noted in sections III and IV.

56. **The National Bank of Georgia has not given priority to the monitoring and enforcement of compliance with IFRS.** The priorities of the NBG have been directed towards prudential regulation and supervision rather than with enforcement of accounting standards.¹² Therefore, compliance with IFRS is primarily subject to the capacity and willingness of preparers to comply and to statutory audit quality. Given the lack of expertise among preparers (refer to Paragraph 31) and significant weaknesses in audit regulation, there is considerable doubt regarding actual compliance with ‘full IFRS’ in the banking sector. However, despite the lack of institutionalized monitoring and enforcement mechanisms, the market perceives banks’ compliance with IFRS to be better than in other sectors of the economy (refer to Paragraph 79 below).

57. **Similarly, the SISSG does not monitor and enforce compliance with accounting requirements, focusing more on prudential regulation.** Its primary focus is enforcing requirements regarding insurance companies’ solvency, which it appears to assess itself based on the financial information submitted to it by the companies. The SISSG should operate in an oversight capacity, reviewing both the financial statements and prudential reporting required of the companies, which would include solvency and asset admissibility information.

58. **The NSC reviews the financial statements submitted by JSCs and highlights poor quality auditing evident from the review to both the Audit Council and the GFPAA.** However, the NSC has only five staff, three of whom are junior, to review the 480 financial statements it receives and is only able to perform a quick scan, chiefly checking for the existence of the primary statements; no confirmation of the content of the financial statements is possible.

59. **Under current law, the Audit Council is responsible for the supervision of auditors;** however it has never fulfilled this role due to inadequate resources and, since June 2005, the removal of the licensing requirement for auditors. There is no little or no cooperation between the Audit Council and other regulatory institutions. Auditing standards are currently only enforced through the limited review of audit opinions by the NSC in its review of the financial statements submitted to it.

60. **The proposed draft Law on Accounting and Audit reintroduces a requirement for professional bodies to monitor the quality of auditors’ service; the outcome of the monitoring should be linked by the organizations to the possible removal of registration.** In addition, minimum retention periods for audit working papers are not currently required by law. Legally required retention of work paper is a prerequisite for enforcement of auditing standards such as quality assurance of auditors or investigative procedures. At present the retention of audit working papers is normally based on the policies of the individual auditors or audit firms.

61. **The results of this lack of enforcement of accounting and auditing standards is that six years after Georgia legally adopted IAS/IFRS and ISA there is still a widespread lack of effective implementation of both sets of standards.** This is true even in some of the large companies and their statutory auditors (if any), for whom the standards are more suitable and who

¹² The National Bank of Georgia receives audited IFRS financial statements from banks and reviews the adjustments made to prudential reporting. The NBG does not review the IFRS financial statements *per se*.

should have resources capable of applying the standards. Implementation and compliance is reported to be ‘good’ or ‘high’ only in the banking sector or where companies have an investment by an overseas interest. A high level of qualified audit opinions in companies audited by international audit firms also emphasizes this implementation gap.

III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

62. **The purpose of this section is to perform the accounting *standard gap* analysis and *compliance gap* analysis.** The *standard gap* analysis compares Georgian accounting requirements with ‘full IFRS’ in order to identify significant differences, which may adversely impact the reliability of financial statements prepared in conformity with Georgian accounting requirements (refer to Paragraph 63 below). The *compliance gap* analysis focuses on the compliance of the statutory financial statements with IFRS and local accounting requirements, respectively, in order to identify any ‘systemic’ non-compliance issues (refer to Paragraph 66 below).

63. **While Georgian legislation (including the proposed draft Law) recognizes IFRS or IFRS-based requirements as the applicable financial reporting standards (refer to Paragraph 10 above), late and poor translation of the standards and override by regulators (e.g., prudential or tax accounting),¹³ give rise to ‘standard gap’ differences between Georgian accounting requirements and ‘full IFRS.’** The following paragraphs highlight selected key differences between Georgian accounting requirements and IFRS that may have a significant impact on the financial statements of *public interest entities*.¹⁴ Paragraphs 64 and 65 below provide a specific analysis of the banking and insurance sectors.

- ***Differences arise as a consequence of the late translation and adoption of IFRS in Georgia.*** As discussed in Paragraph 10 above, companies were required to follow IAS extant in 2000 until the 2004 version of IFRS became applicable on January 1, 2006. Consequently, Georgian accounting requirements failed to incorporate changes made to IFRS/IAS between 2000 and 2004, and now apply 2004 IFRS without changes since 2004.

The draft Law addresses this standards gap by making IFRS as a whole the applicable standards for those entities required to apply them as they are issued, removing the requirement for the standards to be individually adopted into Georgian Law.

64. **There are specific differences between ‘full IFRS’ and Georgian accounting requirements pertaining to banks.** Selected key differences that may have a significant impact on the financial statements of banks include the following:

- ***Interest expense and revenue recognition do not reflect the effective yield, which is likely to overstate income in the banking sector.*** Georgian accounting requirements allow banks to recognize loan origination fees immediately as commission and fee income in the income statement. IAS 39, *Financial Instruments: Recognition and*

¹³ For a discussion of the lack of appropriate linkages between general purpose financial reporting and regulatory reporting, refer to *Implementation of International Accounting and Auditing Standards: Lessons Learned from the World Bank’s Accounting and Auditing ROSC Program*, Hegarty, Gielen, Hirata Barros, World Bank September 2004.

¹⁴ As recommended in Paragraph 85, this report does not recommend the use of IFRS for SMEs. Consequently, the impact of differences between Georgian accounting requirements and IFRS is presented in the context of *public interest entities* (e.g., large enterprises, banks) where this report recommends the use of full IFRS.

Measurement, requires such fees be part of effective interest rate and be credited to the income statement as part of interest income recognition on outstanding balances.

- ***Allowance for loan losses are based on a formulaic methodology, which may result in under- or overstatement of the loan portfolio as compared to IFRS.*** The NBG Regulation on establishing the allowance for loan losses requires banks to calculate impairment in the unsecured portion of loans and receivables on the basis of a provisioning matrix that specifies a range of fixed minimum provisioning rates for each category. While this approach may be adequate for prudential purposes, it does not comply with IAS 39, which requires the allowance for loan losses to be calculated as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate. The use of minimum provisioning rates has the following consequences:
 - It removes a significant amount of judgment from the assessment of loan losses, which greatly simplifies the enforcement of accounting requirements and introduces a certain degree of “prudence” in bank accounts.
 - It may average out the reported results of the banking sector across banks and over time, which may adversely impact the capacity of the NBG to detect changes in banking sector risks and the risks a given bank is taking. It may also hamper market discipline.
 - It may impact interest rate pricing, since banks are required to set aside a minimum amount of provision irrespective of the actual credit risk of a borrower.

Whilst these requirements should only relate to prudential reporting rather than IFRS financial statements, most banks also use the NBG Regulation in preparing their (voluntary) IFRS financial statements.

- ***Suspension of interest accrual on impaired assets is inconsistent with IAS 39 discounted cash flow methodology.*** The NBG Regulations require that banks suspend interest accrual on all loans classified as ‘substandard’ or worse. While suspending interest accrual is rational in the context of a formulaic loan loss measurement methodology, it departs from IAS 39, since it is contradictory to the use of a discounted cash flow measurement policy (refer to IAS 39, Application Guidance (AG), Section 93).

65. **There are specific differences between IFRS and Georgian accounting requirements pertaining to insurance companies.** In addition to 2004 IFRS, insurance companies have to comply with the SISSG regulations regarding the measurement of technical reserves, which are formulaic and differ significantly from the measurement principles that would apply under ‘full IFRS.’ Consequently,

- ***With respect to non-life insurance, the measurement of assets and liabilities, except property valuation (refer to Paragraph 68 below), appears reasonable based on the short-tail nature of the business.*** However, insurance companies appear to lack claims data, which restrict market developments. Insurance companies may wish to share data in line with the *Guidance on Insurance Regulation and Supervision for Emerging Market Economies* issued by the International Association of Insurance Supervisors (IAIS) Emerging Market Issues Committee.

66. **The ROSC assessed the compliance gap sampling:**

- **14 sets of audited financial statements, which purport to be prepared in accordance with IFRS.** For the sample review, the ROSC team selected six

enterprise sector companies, two insurance undertakings, and six banks (including four among the top six banks, accounting for 87 percent of total banking assets).¹⁵ The results of the review are set forth in Paragraphs 67 to 72 below.

- **15 sets of audited and one set of unaudited financial statements, which purport to be prepared in accordance with Georgian accounting requirements.** For the sample review, the ROSC team selected 16 enterprise sector companies.¹⁶ The results of the review are set forth in Paragraph 73 below.

67. **The IFRS consolidated financial statements often include a considerable amount of standard wording, which may not deal adequately with the events and circumstances of that company.** The standard wording is usually drawn from model financial statements provided by the audit firms. In several cases, the standard wording includes accounting policies for events and transactions which are not relevant to the companies concerned. In several instances, management with whom the ROSC team met was unable to discuss the recognition and measurement principles and the disclosures in their IFRS financial statements.¹⁷ According to some, the use of standard wording reflects the lack of knowledge and understanding of IFRS and IFRS financial statements among accountants employed by companies. The audit firms assert that they do not ‘prepare’ those financial statements, and that they assist only as far as is ethically permissible. The standard wording also reduces the relevance of those financial statements to external users.

68. **There is a shortage of internationally recognized expertise on the valuation of property, plant and equipment, which brings into question the reliability of valuations used on privatizations, business combinations and other non-cash transactions.** It is understood that there is no valuation firm in Georgia which employs valuation experts with internationally recognized qualifications. Many local valuation experts do not have such qualifications and allow different valuation bases, with the result that some audit firms are unwilling to rely on their valuations. Some companies had never had unqualified audit opinions due to an inability to properly value their PPE. This is a major problem for foreign and internal investors in privatization processes and other corporate investment.

69. **While the quality of bookkeeping for cash and similar transactions is of a high level, companies struggle to deal with accruals-based accounting and disclosures.** Companies are able to cope well with cash and similar transactions as a result of the disciplines imposed under the former regime. Companies are less able to cope with accrual accounting, which requires the recognition of assets and liabilities which are not the subject of invoices or other prime records (for example, the recognition of provisions, impairment of assets, and deferred tax). They also have difficulty identifying intra-group transactions as their identification was unnecessary in the past because of either the focus on legal entity financial statements or the lack of group structures. The difficulties are compounded when companies undertake business deals outside their normal operating procedures. Companies are also less able or willing to cope with the identification of information required for related party disclosures as well as the other extensive disclosures required by IFRS. A further source of differences arises as a consequence of the issuance of NSC

¹⁵ All financial statements in the sample were audited by local member firms of international audit firm networks with the exception of two sets of financial statements, which were audited by local audit firms with no international affiliation. Nine audit reports were unqualified (three included an emphasis of a matter paragraph) and five were qualified (all of which in the enterprise sector).

¹⁶ All sets of financial statements in the sample are audited by local audit firms with no international affiliation. Thirteen audit reports were unqualified and two were qualified.

¹⁷ Lack of management ownership for ‘their’ IFRS financial statements was particularly prevalent in the enterprise and insurance sectors and among smaller commercial banks.

Regulation No. 54 which gives a recommended format for registrants of the NSC to use in preparing their financial statements. Unfortunately, many preparers believe that they have only to fill in the recommended format to comply with IFRS. Consequently, they merely transfer numbers from the tax financial statements into the recommended format without the necessary adjustments. Also, most preparers do not add narratives in the notes relating to accounting policies and related parties.

70. The level of compliance with IFRS in the sample's six enterprise sector companies, two of which are State Owned Enterprises (SOEs) was very low. This materially reduces the usefulness of these companies' financial statements and renders them useless in many cases:

- Only one of the six companies had an unqualified audit report on their financial statements. Many of the qualifications were for fundamental errors or an inability to satisfactorily audit key major balances such as fixed assets. The high level of audit qualifications in the non-financial sector companies clearly indicates a significant compliance gap. Having an unqualified audit report is critical for external users and in particular for investors who rely on financial information they can trust to make investment decisions.
- Compliance with IAS 24, *Related Party Disclosures*, was poor. Major issues included inadequate or non-existent disclosure and inappropriate accounting for related party commitments in a business combination. Investors and external users need full disclosure of related parties and associated transactions to be able to accurately ascertain the value of the entity in which they may invest. In particular, foreign investors will avoid any entities, or even economies, where there is a perception that 'hidden' related parties exist.
- Compliance with IAS 16, *Property, Plant and Equipment (PPE)*, was poor. Significant issues and errors observed included not calculating residual values, combining revaluation surplus with additions, giving unclear disclosure of movements, and not disclosing required information about valuations. The two SOEs use regulatory valuations rather than fair value. Two of the companies had qualified audit opinions due to inaccurate PPE. This observation was confirmed when the ROSC team met with companies in Georgia.
- The two SOEs both had their audit reports extensively qualified due to limitation of scope and non-compliance with IFRS. The level of compliance appeared to be even lower for these entities than for the other enterprise companies. This may hinder and delay any future privatization process, as reliable financial statements are often a prerequisite for such a process and it may hinder proper management accountability if the entities stay state-owned.

71. The level of compliance with IFRS in the sample's six banks was better than in the non-financial sector companies but is still low in places. There was a 'compliance gap,' which may materially reduce the usefulness of banks financial statements, particularly to regulators:

- The audited IFRS financial statements of the commercial banks reviewed by the ROSC team had unqualified audit opinions, although two had 'emphasis of matter' paragraphs. This compares favorably to the non-financial sector companies, and confirms the view that the level of compliance with IFRS in the banking sector is higher than outside of it. However, there were some major non-compliance issues noted.
- Compliance with IAS 39, *Financial Instruments: Recognition and Measurement* was poor in places. Disclosures relating to the assessments of fair value of financial

instruments were not compliant with those required by IAS 39. Similarly the disclosure of the measurement policy relating to possible impairment of financial assets was poor; in some cases the policy did not appear to be compliant with IAS 39. For example, all of the banks recorded a general allowance for loan losses in their IFRS financial statements, which may contradict IAS 39. Four of the banks' financial statements stated that interest is not accrued on delinquent loans, which may contradict the use of a discounted cash flow measurement policy required by IAS 39.

- Compliance with, and disclosure of, regulatory requirements is poor in places. Some of the banks disclosed very little information regarding the banks' compliance with regulatory requirements, including capital adequacy, open foreign exchange positions, and liquidity.
- The ROSC team noted in discussions with the banks that, in some cases, the banks' use of foreign exchange derivatives does not appear to be reflected in their IFRS financial statements. This deficiency is a fundamental error which materially misleads users of the financial statements as to the banks' foreign exchange risk exposure and management.

This non-compliance and poor disclosure make it difficult for foreign users and national regulators to analyze a bank's performance and to gain the information they need regarding the banks' liquidity and financial stability. In addition, inconsistency in application across the sector hinders comparability of banks' performance.

72. The 'compliance gap' for insurance companies was similar to the banks. Compliance with IFRS in the sample's two insurance companies was better than for non-financial entities but is still low in places:

- The audited IFRS financial statements of the insurance companies reviewed had unqualified audit opinions although one included an 'emphasis of matter' paragraph. The emphasis of matter stated that the company had assets under management included on the balance sheet, but little information was provided as to which assets this related to. As with the banks, these unqualified opinions compare favorably to the non-financial sector companies, and confirm the view that the level of compliance with IFRS in the financial sector is higher than outside of it.
- Compliance with IFRS 4, *Insurance contracts*, was low in places. Examples of non-compliance include companies showing insurance income gross, including insurance premium taxes, whereas IFRS requires that income be shown net of tax; companies not addressing certain operational risks that require recognition of a liability under IFRS, either actual or contingent (as a 'contingent obligation'). Disclosure was inadequate in many cases to satisfy the requirements of IFRS. Such non-compliance makes it difficult for regulators, policyholders and other users of the financial statements to gain the information they need regarding the insurance companies' solvency and financial stability.
- Insurance companies had similar problems regarding effective and accurate valuation of assets as is noted above in Paragraph 68 due to a shortage of valuation experts. This is particularly problematic in the valuation of property where there is in addition often a lack of historical cost information.

73. The 'compliance gap' for the sample's 15 audited and 1 non-audited financial statements of the entities required to use Georgian accounting standards was very large. The quality of financial statements, which purport to comply with Georgian accounting requirements, was generally very weak with a number of significant non-compliance issues

as noted below. These issues were so significant that, in most instances, users of these financial statements would be unable to make an informed decision on their basis or could actually be misled in their decision-making process:

- A number of financial statements lacked any accompanying notes, which would include fundamental information about the basis of preparation of the financial statements and the accounting policies used. This absence significantly reduces the usefulness of the financial statements.
- Several financial statements were based on the illustrative financial statement format issued by the NSC and did not exclude line items which were irrelevant to the companies' operations, showing the full format with zeros in redundant lines. This indicates a basic misunderstanding of the use of such formats and illustrates the preparers' fundamental lack of understanding of the financial statements and the applicable standards.
- A number of the financial statements reviewed were not complete and lacked the minimum line items that are required to be presented on the face of the financial statements. Some did not identify the balance sheet date or the period covered by the financial statements. A number of inconsistencies and arithmetical errors were observed in the financial statements including some figures on the face of the financial statements not agreeing with the notes. In a number of the financial statements no comparative information was disclosed.
- A number of the financial statements submitted the same numbers in their tax accounts and financial statements, simply using the illustrative format for the financial statements. In addition, a number of the audit opinions were given on the tax accounts rather than the financial statements. This again illustrates the preparers' and auditors' lack of understanding of fundamentals of corporate financial reporting such as the separation of tax accounts and financial statements.
- Only two of the 15 sets of audited financial statements had qualified audit opinions. However, the review noted such fundamental non-compliance in the financial statements that the high number of unqualified opinions is likely to indicate poor audit quality rather than high quality financial reporting.

IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

74. **Georgian auditors and audit firms are obliged to use International Standards on Auditing as promulgated by the IAASB.** The Audit Council sets out that ISA are automatically approved for Georgia when they are released by the IAASB. The proposed draft law on Accounting and Audit confirms the adoption of ISAs. Thus, ISA do not need to be translated to be legally binding in Georgia. The translation simply follows and the individual auditor has the duty to inform himself of recent changes in ISA. As with IFRS, time lags and quality issues in the translation can lead to minor 'standards gaps', but the effects of these is minor when compared with the significant 'compliance gap'.

75. **While the wording of the auditors' opinions given on the financial statements in the IFRS sample appeared to show reasonable compliance with ISA, the audit opinion wordings of the second sample of companies using Georgian accounting standards were very poor and the 'compliance gap' so large that an unqualified audit opinion on these financial statements would appear to be misleading any user of the accounts by confirming proper financial statement preparation which even a cursory review can indicate is not appropriate.** The ROSC team noted the following issues in the review of audited financial

statements (refer to Paragraph 66 above) and during discussions conducted by the ROSC team with auditors at small and large audit firms in Georgia:

- 12 of the 14 IFRS audited financial statements reviewed in the first sample were audited by local member firms of international audit firm networks. One of the banks and one of the insurance companies were audited by Georgian audit firms. All of the audit opinions stated that the audit work had been performed in compliance with ISA, with the exception of the two SOEs where no such statement was given. Whilst it is not possible from a review of the opinions and brief meetings to conclude on the quality of work done, the larger local member firms of international audit firm networks appeared to conduct a more sophisticated and thorough audit than the smaller local member firms or local firms, though not all staff from even the largest firms appeared to fully understand the audit process. It was clear from the perceptions of some of the large companies, regulators, and the auditors themselves that there are in effect three tiers of audit firms with the leading international firms in the first tier, the smaller international and leading local firms in the second tier, and smaller local firms that provide audit and other financial consulting services in the third tier.
- As stated above, five of the 14 financial statements had qualified audit opinions and a further three had unqualified opinions with emphasis of matter paragraphs. A review of the reasons given for qualification of the opinion or the emphasis of matter paragraphs generally supports their appropriateness. Some opinions had multiple reasons for qualification, each of which would have lead to a qualification.
- Compliance with ISAs in the audits of the sample of companies using Georgian accounting standards appeared to be very low. Many of the financial statements showed fundamental errors and weaknesses, but received unqualified audit reports. Many of the opinions given were non-standard; some did not refer to any auditing standards used, others referred to the Georgian Law on Audit. Some opinions were given on tax accounts, or did not state to which financial statements the opinion relates.
- The auditors of the 15 audited financial statements in the second sample were all in the 'third tier' of smaller local audit firms. Some were sole practitioners; others had 'consulting' in their company names, indicating that audit was only a part of their practice.

76. **The significant variations in audit quality noted above are caused by major differences in the technical proficiency, level of experience and level of resources across the audit firms.** The ROSC team noted a wide range in the use of developed audit methodologies across auditors in Georgia; local member firms of international audit firm networks have the benefit of fully developed audit methodologies (though this does not mean the methodology is always used accurately). They also may have firm-wide internal quality control procedures, often benefiting from resources from outside Georgia.

77. **By contrast, independent Georgian audit firms have often had to develop their own audit methodologies intended to be in accordance with the translated ISA.** Lack of access to proper audit methodology hinders local firms' access to the audit market and restricts the quality of their audit work. The level of compliance with auditing standards is closely related to the quality of the audit methodology used by the audit firm.

78. **Like the insurance industry itself, in terms of insurance specialists, the audit profession is at an early stage in its development regarding the audit of insurance companies.** In terms of testing the completeness and accuracy of claims reserving, the audit profession does not appear to be any further advanced than the insurance companies that are

subject to their review. The insurance business currently being written in Georgia is not of a highly technical nature and its auditing of can largely be covered by ISA 540, *Audit of Accounting Estimates*, ISA 500, *Audit Evidence*, and possibly ISA 620, *Using the Work of an Expert*.

V. PERCEPTION OF THE QUALITY OF FINANCIAL REPORTING

79. **There is a general perception that, with the exception of banks, the financial statements in Georgia are of a low quality.** The market attributes the higher perceived quality of the banks' financial statements to the closer monitoring and enforcement from the National Bank of Georgia, the banks' ability to attract professionals with a better understanding of IFRS, and the fact that the top six banks are audited by local member firms of international audit firm networks. On the other hand, the market attributes the poor perceived quality of the financial statements of other entities to limited demand for financial information from third parties, dominance of tax reporting in the absence of other demand, limited or no enforcement by the appropriate authorities, and limited capacity due to lack of understanding of and sufficient technical training in IFRS.

80. **Commercial banks do not rely on the financial statements presented by potential borrowers in determining whether to extend credit.** Although entities are required to submit their financial statements as part of the loan application process, banks base their lending decisions on other factors including amount of collateral, business forecasts and site visits.

81. **Audited financial statements have little value or no value because there is an overwhelming perception that audit opinions can be 'bought' in Georgia.** This view was held by various regulators, commercial banks, educators, accountants and auditors. The previous lax audit licensing requirements and the current lack of audit licensing requirements are directly related to this state of affairs. As discussed in Paragraph 55, there is no quality control requirement in place at the present time. This lack of monitoring of auditors and enforcement of auditing standards exacerbates the problem of poor quality audits in Georgia, in general.

VI. POLICY RECOMMENDATIONS

82. **The principal objective of this ROSC assessment is to assist the authorities and other stakeholders in strengthening the financial and non-financial sectors' accounting, financial reporting and auditing practices, as a means to support certain relevant strategic objectives for Georgia, including:**

- Enhancing the business climate and bolstering domestic and foreign direct and portfolio investment in the private sector;
- Stimulating growth in the SME sector by facilitating the SMEs access to credit from the formal financial sector by shifting gradually from collateral-based lending decisions to lending decisions based on the financial performance of the prospective borrower;
- Supporting the stability of the banking sector and mitigating the risk of crises due to loan collection problems and helping mobilize domestic savings; and
- Achieving greater financial transparency in the corporate sector, both State and private-owned, thus allowing shareholders and the public at large to assess management performance and influence its behavior

Without attempting to provide a detailed tactical design for reforms, this report sketches the policy recommendations to enhance the quality of corporate financial reporting.

83. **The recommendations of this ROSC are interrelated and mutually supportive, designed to collectively improve the financial reporting environment in Georgia.** For example, superb accounting standards are jeopardized at the beginning if people do not understand how to translate the standards into journal entries and a rigorous statutory and regulatory framework is unlikely to be effective if it is not enforced. Additionally, as illustrated in Figure 1 in the Executive Summary, some recommendations will not have an immediate effect but are still high priority if the financial reporting environment in Georgia is to be upgraded to international standards within a reasonable timeframe.

84. **The recommendations as a whole address the key priorities of the financial reporting and accounting environment in Georgia which are the education of the accounting and auditing professions and an enhanced effective regulatory framework which will enhance the perception of financial reporting and the reputation of the profession. All involved with financial reporting – accountants, auditors, regulators and users of financial statements - stand to gain from the timely and successful implementation of the recommendations.**

85. **Accordingly, this report recommends that the Statutory Framework:**

- requires legal entity and/or consolidated financial statements to be audited only when there is a public interest for such an audit – this is defined in the draft Law as banks, listed companies and certain other entities. However, should these requirements still result in a situation where the number of audits required by law is excessive as compared to the availability of qualified auditors in the market, policymakers should phase in these requirements with a view to ensuring that statutory audit requirements do not crowd out Georgia’s audit capacity.
- requires all statutory audits to be conducted in compliance with ISA. Policymakers may however wish to adopt the ‘ISA Plus’ model, whereby—while ISA would be adopted in full—additional standards and audit procedures may be imposed if they follow from specific requirements relating to the scope of the statutory audit (e.g., an additional requirement for bank audits to contribute to the prudential supervisory process).
- requires all auditors and/or audit firms to be registered for audit with a professional organization. The proposed draft Law proposes that this registration be undertaken by professional organizations that are registered in Georgia and are full members of IFAC. Accordingly, those organizations should be required by the Law to comply with IFAC guidelines for such registration.
- establishes a mechanism such that the professional organization(s) perform the following functions effectively and on a timely basis, free from undue influence and bias:
 - translation of IFRS; development of the reduced ‘temporary accounting standards’
 - translation of auditing standards,
 - adoption of an ethical code or standards for auditors and/or accountants,
 - the registration of auditors,
 - the monitoring of the quality of auditor’s work,

- the recognition of audit qualifications, and
- investigation of complaints relating to certified auditors.

If, as proposed by the draft Law on Accounting and Audit, the above functions are delegated to professional organization(s) then the organization’s performance of those functions should be independently monitored to guard against undue influence and potential corruption.

- increases the accountability of preparers of financial statements. In order to enhance directors’ accountability, all board members should be collectively responsible, both in law and in practice, for the probity of legal entity and consolidated financial statements. This should discourage excessive reliance on auditors in the preparation of financial statements. To strike a balance, Georgia does not want regulations and practices so stringent that honest, capable people are put off from serving on boards, but equally the law and practice must be robust to deal fairly when something goes wrong. This is a matter of company law and would not be within the remit of the draft Law on Accounting and Audit.
- requires *public interest entities* to make their audited legal entity and consolidated (if any) financial statements readily available to the public¹⁸ within a reasonable period after the balance sheet date. Such a requirement exists under banking and JSC regulations but is not widely complied with.

These recommendations would result in a statutory framework comparable to existing frameworks in EU Member States consistent with the requirements of the EU Company Law Directives as they relate to the regulation of financial reporting and audit.

86. With regard to accounting standards, this report recommends:

- the enhancement of the existing translation process resulting in a sustainable translation process in Georgian language whereby the official translation of IFRS is readily available and affordable across the country. This translation process should also be leveraged in the context of the translation of ISA.
- that policymakers and regulators revisit the relationship between prudential and general purpose financial reporting in the financial sector. Using IFRS for prudential reporting is often a source of concern to supervisory authorities in the financial sector, notably because of fears that these standards could jeopardize the criteria that “regulatory own funds” have to fulfill, namely that they be (i) permanent, (ii) readily available for absorbing losses, and (iii) reliable as to their amounts. There are also some concerns that IFRS introduce volatility into financial institutions’ financial statements and, more particularly, into regulatory own funds, in ways which might not reflect the economic substance of institutions’ financial positions.
- that the NBG and the SISSG should develop prudential filters for regulatory capital with a view to adjust regulatory own funds for changes appearing in the accounting equity of financial institutions applying IFRS. In this context, the NBG and the SISSG could draw on the work conducted under the auspices of the Basel Committee on Banking Supervision and the Committee of European Banking Supervisors. This approach would make clear the distinction between prudential and general-purpose financial reporting. However, since the regulators would have a keen interest in ensuring that the IFRS-based financial statements are correct—since their reports

¹⁸ The equivalent requirements exist in EU Member States as set forth in the EU Fourth and Seventh Company Law Directives, and the Transparency Directive.

would be built on that foundation—this would mobilize them to assist in the enforcement of IFRS compliance in general purpose financial statements as well.

87. **With regard to auditing standards, this report recommends:**

- the enhancement of the existing translation process resulting in a sustainable translation process in Georgian language whereby the official translation of ISA is readily available and affordable across the country. This translation process should also be leveraged in the context of the translation of IFRS.
- in the medium term, the development of an ISA compliant standard audit methodology and audit manual for the smaller audit practices, which would then allow the audit profession of Georgia as a whole to improve the quality of the auditing function and which would, in turn, lead to an increase in public confidence in the reliability of the information contained in financial statements. Training courses on the implementation of the methodology should also be developed and made available.

88. **With regard to the monitoring and enforcement of accounting and auditing standards, this report recommends:**

- subjecting all auditors and audit firms to a system of quality assurance. The results of the external quality assurance system should be instrumental in the registering organization's decision whether to continue the registration, or issue it subject to restrictions and/or conditions. Extreme cases could result in a referral to an investigation or disciplinary process. The staff of this monitoring function must be credible and command respect within the profession; the staff should be adequately remunerated to attract and retain candidates with the required experience and caliber. Quality assurance for the audit is fundamental for ensuring good audit quality, which adds credibility to published financial information which encourages foreign and internal investment and adds value and protection to shareholders, investors, creditors and other stakeholders.
- structuring the quality assurance system for auditors such that the monitoring visit cycle should be linked to the level of public interest in the firm's clients. An audit firm that audits the largest firms in Georgia, or firms with specific public interest clients such as banks, insurance clients or listed companies, should be visited more frequently than auditors with less public interest clients. A minimum cycle should be set over which all registered firms are visited at least once – this might typically be 6 years. Where audit firms have, or wish to have, regulated clients the monitoring process should particularly focus on the audit firm's capabilities to provide adequate specialist audit services. This would ensure that auditors of regulated entities have appropriate skills and resource.
- the establishment of an effective system of investigations and sanctions for potentially serious misconduct relating to audit. In addition to removal of audit registration, the system may provide effective, proportionate and dissuasive civil, administrative or criminal penalties in respect of statutory auditors and audit firms, where statutory audits are not carried out in conformity with the Audit Law, ISA, and/or the Code of Ethics for Professional Accountants. Serious disciplinary measures taken or sanctions imposed on statutory auditors and audit firms should be appropriately disclosed to the public. The system may wish to draw upon existing practices in EU Members States and IFAC SMO 6, *Investigation and Discipline*.

- systematic follow-up by the SISSG, NBG or the NSC upon receipt of a qualified auditor's report relating to the financial statements of one of their regulated entities. The results of the NSC, NBG and SISSG's reviews of the financial statements of regulated entities should be communicated where relevant directly to the audit registering body. Such reviews should consider the whole financial statements, including the notes, and compare information to separately provided prudential information where appropriate.
- the establishment of a reliable claims database that will help insurers and supervisors confirm the right price for various categories of products in accordance with The International Association of Insurance Supervisors' Guidance Paper No. 1, *Insurance Regulation and Supervision for Emerging Market Economies*.
- the enhancement of the NBG's, the NSC's and the SISSG's relationship with statutory auditors to mutual advantage. The supervisors may also consider requiring the statutory auditor to carry out specific assignments or issue special reports to assist the supervisors in discharging their supervisory functions.
- the development of a mutually acceptable approach to the audit of technical reserves. Without a functioning life insurance industry, Georgia may not have the actuarial capacity or sufficiently advanced technical insurance needs to justify onerous actuarial certification requirements. The Georgian Association of Actuaries and Financial Analysts should incorporate this approach in to their actuarial qualification.
- that the SISSG take responsibility for the supervision of insurance companies' marketing information and policy wordings to ensure consistent high standard, of open and transparent information for the public. This information was required to be submitted to the SISSG prior to the recent simplification of licensing arrangements.
- in the short to medium term, that the NBG, NSC and the SISSG employ more staff who are familiar with IFRS and encourage those staff to stay up to date with IFRS as it evolves. The supervisors should also consider arranging internships for staff with overseas peer institutions. The aim for all the regulatory bodies should be a regime of enforcement which incentivizes firms to comply by making the rewards of compliance greater than the costs of non-compliance.

89. With regard to the development of the accounting and auditing profession, this report recommends:

- the establishment of a registration requirement for all individuals who wish to obtain the right to conduct audits in Georgia. If this registration is administered by professional organizations, as is proposed under the draft Law, then the professional audit qualification of each organization should be required by the Law to comply with IFAC Education Standards i.e. it should comprise an examination of professional competence and a requirement for suitable and adequate relevant professional experience and should:
 - draw upon International Education Standards established by the International Accounting Education Standards Board of IFAC, in particular IES 8, *Competence Requirements for Audit Professionals*¹⁹, IES 6, *Assessment of Professional Capabilities and Competence* and IES 5, *Practical Experience Requirements*.

¹⁹ Currently an IFAC exposure draft

- include procedures for the approval of individuals who hold adequate foreign accounting qualifications subject to a test of the relevant laws and regulations of Georgia for audit purposes.
- include procedures for holders of the existing audit certification issued by the Audit Council and existing GFPAA members such that they should meet all, or substantially all, of the requirements for the main qualification to obtain the qualification (such transitional procedures are proposed in the draft Law).

Such a qualification procedure is comparable to existing practice in EU Member States under the Eighth Company Law Directive.

- the establishment of a publicly-available electronic register of auditors and audit firms so that interested parties can determine rapidly whether a auditor or an audit firm has been registered for audit. Under the proposed draft Law, this register would be held by the professional organizations. Availability of the public register in foreign language would greatly increase its usefulness especially in the context of foreign direct or portfolio investment.²⁰
- that the GFPAA continues its key role in leading the accountancy and audit profession in Georgia. In this context, the GFPAA should:
 - Seek to include as associate members all of those working as accountants and in particular all ‘chief accountants’,
 - Make studying for qualifications as accessible as possible, especially for those who have learnt under previous regimes, by emphasizing that such learning is ‘updating’ knowledge rather than starting from no knowledge base.
 - Encourage all members to maintain and enhance their professional competence through CPD.
 - Regulate the audit profession to the extent delegated to it by the Law

90. **With regard to education and training the report recommends:**

- encouraging ‘chief accountants’ and other preparers of financial statements at Georgian companies to improve their understanding of IFRS, accrual accounting, and their application to their work within the financial reporting framework in Georgia.

On the demand side, policymakers could incentivize company management to invest in such ‘retooling’ through a combination of positive incentives and deterrent incentives (e.g., liability for the probity of financial statements as set forth in Paragraph 85 above). In the context of State Owned Enterprises (SOEs), the State, acting as a shareholder, could take the lead and ensure that accountants in SOEs enroll in ‘retooling’ programs. Companies should also be encouraged to support employees’ training and study towards accountancy qualifications.

²⁰ The register should include the following information:

- Individual statutory auditors: They may be responsible for audit work at an audit firm, or self-employed as indicated on the register.
- Audit firms: The register should show the number of statutory auditors employed by or associated as partners or otherwise with the audit firm. The register should contain information on the ultimate owners and members of the management of the audit firm. Furthermore, the register should also comprise information on the membership of a network, indicating with which other audit firms/affiliates the audit firm cooperates and, by doing so, making these networks more transparent to interested parties.

On the supply side, private sector accountancy education centers could also be incentivized to open in Georgia through specific measures. Their offering should however be tailored to the needs of Georgian companies. The core concepts, such as the accrual basis, the separation of reporting for tax purposes and financial reporting, and the interaction of financial statements, management accounting and cash flow accounting, should be central to the education of the profession.

- that the GFPAA provide a recognized qualification which ‘chief accountants’ and other accountants in industry would aspire to, which would be affordable and within their capabilities. The absence of such an intermediate qualification risks disenfranchising the majority of the current accountancy profession in Georgia
- better integration of the range of accountancy education and training (refer to Paragraph 40 above). In this context, the GFPAA should:
 - work with the ACCA to bring the quality of its ‘Georgian ACCA’ qualification up to as close to the standard of the English-language ACCA as possible through improvements to the examinations, which should be set in a similar manner and to a similar standard as the ACCA English-language exams. In addition, the GFPAA should support its members (and others) who wish to take English-language qualifications.
 - work closely with the universities and other providers of higher education to coordinate syllabuses such that, where appropriate, exemptions can be granted for stage one (or conceivably stage two) examinations in the GFPAA’s professional qualification. Close cooperation gives advantages for all – students benefit from reduced time and cost, the universities gain through improvements in course quality and the GFPAA/profession benefits from attracting more able students into the profession who can graduate to full membership more quickly.
- that key operational staff are seconded from the supervisory agencies to similar agencies abroad for ‘on the job training’ on best international practices regarding monitoring and supervision in respective areas as well as IFRS.
- that the Georgian actuarial qualification offered by the Association of Actuaries and Financial Analysts should seek accreditation from, or affiliation to, an international association. This would lead to a better market understanding of the qualification’s standard.