

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

## Slovakia

### ACCOUNTING AND AUDITING

Prepared by a staff team from the World Bank<sup>1</sup> on the basis of information provided by the Authorities of Slovak Republic

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#### Executive Summary

This report on the strengths and weaknesses of Slovakia's institutional arrangements for observance of the International Accounting Standards (IASs) and International Standards on Auditing (ISAs) is based on a self-assessment of accounting and auditing practices in the country. The self-assessment exercise was conducted under the management of a National Steering Committee consisting of representatives from government and private sectors, and was assisted by Bank staff.

Slovakia's legislative requirements on accounting and corporate financial reporting seem to be geared toward satisfying the information needs of the tax authorities only; other users, including investors and creditors, have difficulty in making meaningful use of the financial statements for market-oriented decision making. There is a large gap between Slovak accounting requirements and the IASs. Although listed companies are required to prepare financial statements in accordance with the IASs, in addition to statutory annual financial statements, there is no mechanism to monitor and enforce this requirement. As a result, many of the statements presented as IAS financial statements do not fully comply with the IASs.

In the auditing area, too, a number of problems indicate the need for a well-organized reform program: auditors' failure to comply with internationally comparable independence and ethical requirements, inadequate capacity of the Slovak Chamber of Auditors (SKAu) to properly regulate the profession, shortcomings in educational and training arrangements with regard to the practical application of high-quality accounting and auditing standards and requirements, and absence of effective mechanisms for enforcing established rules and regulations. The National Steering Committee in a joint meeting with World Bank Staff agreed with various policy recommendations that will form the basis for designing and implementing a Country Action Plan to address the issues concerning accountancy development and observance of international accounting and auditing standards in Slovakia.

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## I. INTRODUCTION

1. Accounting and auditing practices in Slovakia were assessed as part of the Bank-Fund joint initiative on the Reports on the Observance of Standards and Codes (ROSC). The assessment focused on the strengths and weaknesses of the accounting and auditing environment that influence the quality of corporate financial reporting, and used the International Accounting Standards (IASs) and the International Standards on Auditing (ISAs) as benchmarks. The assessment used a diagnostic template developed by the Bank to review requirements and actual practices.

2. The assessment process was managed by a National Steering Committee (NSC) established through a joint initiative of the Ministry of Finance and the Slovak Chamber of Auditors. The NSC is headed by a State Secretary of Finance, and is strongly supported by Slovakia's Deputy Prime Minister and Finance Minister. It includes representatives from the Ministry of Finance, National Bank of Slovakia, Financial Market Authority, Bratislava Stock Exchange, Economics University, Bankers Association, Association of Insurance Companies, Slovak Association of Corporate Financiers, Slovak Chamber of Auditors, Union of Bookkeepers, and international and local audit firms. Various subcommittees of the NSC carried out different aspects of the assessment, and Bank staff reviewed their work and prepared this report on the basis of their findings.

3. Slovakia, which has a population of about 5.5 million, became an independent country upon the peaceful division of Czechoslovakia on January 1, 1993. It has been an associate member of the European Union (EU) since October 1993, and negotiations for it to be admitted as a full member of the EU were officially opened in February 2000 with target completion by the year 2004. A democratic change of government in September 1998 accelerated the privatization process that had begun with the collapse of the centrally planned economy. Foreign strategic investors have acquired majority stakes in many enterprises, including those that were previously reserved as state monopolies. Although there is no restriction on foreign investment in local securities markets, foreign portfolio investment in the country is negligible. The absence of arrangements to protect minority shareholder interests and lack of investor confidence, among other things, have restricted liquidity in the country's securities markets. The availability of internationally comparable financial information would permit foreign strategic investors to evaluate risk and return on securities investment in the country, properly assess the productivity of their investments, and prepare consolidated financial statements. The country authorities recognize the need to attract and retain foreign direct and portfolio investments, and the importance of the role of transparent corporate financial reporting in strengthening national financial system, and they are eager to create an enabling environment for the observance of international accounting and auditing standards.

## II. INSTITUTIONAL FRAMEWORK

### A. Statutory Framework

4. **The Act on Accounting provides a broad framework for bookkeeping and financial reporting.** The Act authorizes the Ministry of Finance to develop standardized charts of accounts and detailed instructions on the accounting treatments of various transactions. However, it appears from the legislative requirements that the main purpose of accounting and financial reporting is to facilitate computation of taxable profit rather than to meet the information needs of investment decision makers and various other stakeholders. This has constrained the development and implementation of rules and regulations that are conducive to high-quality financial reporting in a market economy.

5. **Although many business enterprises are required to have an annual audit, the objective of the audit is unclear.** According to the Commercial Code and the Act on Accounting, the following accounting entities (enterprises) are required to have their annual financial statements audited: joint stock companies (includes all banking and insurance companies); and other business entities, including limited liability companies and cooperatives, if they met any two of the following conditions in the preceding year— (a) total value of the entity’s assets exceeded SKK 20 million, (b) the entity’s net revenue from sale of goods and services exceeded SKK40 million, or (c) the average number of employees exceeded 20. The Act on Accounting requires that the statutory audit should be performed within one year from the balance sheet date of December 31, and tax legislation requires that tax returns must be submitted by March 31 along with the annual financial statements (which need not be audited). Some practicing auditors in the country raised an issue that calls into question the objective of the statutory audit: the draft (unaudited) financial statements submitted to the tax authorities often contain accounting numbers that the company management is inclined to maintain in the ultimately audited financial statements. This is because, if the accounting numbers in the audited financial statements differ from the accounting numbers submitted with the tax return, the tax authorities may impose penalties for “inaccurate” accounting treatments in the draft financial statements.

6. **The Act on Auditing gives the Slovak Chamber of Auditors (SKAu) legal authority to regulate the audit profession.** According to the Act, the SKAu administers the qualifying examination and licenses qualified auditors; however, the chairperson and members of the examination board are appointed and removed by the Ministry of the Finance, and the SKAu’s decisions on the scope and contents of the professional examination are subject to approval by the Ministry of Finance. All licensed auditors in the country are members of the SKAu; membership is also given to legal entities (public limited companies, limited liability companies, or limited partnerships) in which Slovak licensed auditors hold the majority voting right, and to individuals licensed to practice as auditors in OECD countries. The SKAu is legally authorized, among other things, to issue auditing standards and ethical requirements in compliance with international standards, monitor members’ performance of audit work, and take necessary actions to enforce audit-related rules, regulations, and standards.

7. **The Securities Act requires all listed companies to present annual audited financial statements prepared in accordance with the IASs.** This requirement is in addition to the requirement on statutory financial reporting based on local accounting rules and regulations. However, because there is no enforcement mechanism, listed companies generally ignore the requirement and follow the accounting regulations set by the Ministry of Finance. The Bratislava Stock Exchange (BSSE) does not require any additional disclosures in listed companies' annual financial statements. The issues traded on the BSSE fall under three segments: *listed securities*—11 equity securities and 50 bonds; *registered securities*—50 equity securities and 60 bonds; *free market*—848 equity securities. On July 1, 2001, the first two segments—listed securities and registered securities—were merged, and the market is now divided into the segments *listed market* and *free market*.

8. **The Act on Banking requires bank auditors to provide early warning to the banking supervision authority about potential financial problems in audited banks.** Effective from July 1, 2001, the new Act on Banking requires the auditor of a bank to immediately notify the National Bank of Slovakia (NBS) and its Supervisory Board, in writing, of the facts leading to an expression of qualified audit opinion on the annual financial statements of the auditee bank. The auditor is also required to notify the authorities of any negative equity and of any indication that the bank has violated legal requirements or has provided untrue, incorrect, or incomplete information in financial statements and other reports submitted to the NBS. The Act further requires the auditor to provide documentation about these matters if requested in writing by the NBS, and authorizes the NBS to disqualify from auditing banks any auditor who fails to comply with these requirements. The Act provides that a bank's appointment of an auditor needs final approval from the NBS.

## B. The Profession

9. **The Slovak Chamber of Auditors (SKAu) has 767 members involved in performing audit activities.** In addition, 196 corporate members provide audit services. Membership grew by 43 in 1998, 69 in 1999, and 53 in 2000, and it is expected that the total number of licensed auditors in Slovakia will increase to over 1,100 by the year 2004. This number seems sufficient to meet the demand for qualified auditors in the country. However, it appears that at present many licensed auditors lack the expertise to conduct audits in accordance with the standards and guidelines issued by the International Federation of Accountants (IFAC). This is due mainly to the fact that the modern concept of audit did not exist under the centrally planned economy, and the academic education and professional training of most of these professionals did not expose them to modern audit procedures.

10. **Although the audit market is dominated by the local member firms of big-5 international accounting firm networks, other domestic firms audit many of the largest enterprises.** All five of the big-5 member firms are among the six largest audit firms in Slovakia. According to a survey conducted by the local publication *TREND*, the big-5 member firms audited 33 percent, and 45 domestic firms audited 67 percent, of the

1999 financial statements of the top 200 companies in the country. However, the companies audited by the big-5 member firms are the most significant economic entities in the country—for example, 40 of the 50 banks and insurance companies. In many cases the big-5 member firms subcontract parts of large audit assignments to domestic audit firms. It follows, therefore, that the quality of the audit of large enterprises in general depends on the performance of not only the big-5 member firms but also the large and medium-size domestic firms.

11. **In recent years, the financial sector has faced serious problems.** The banking sector accounts for more than 85 percent of Slovakia's financial sector, and its assets account for about 90 percent of GDP. The rest of the financial sector is still very small. Huge directed loans made under the communist regime, combined with insufficient loan-loss provisioning and camouflaged related-party transactions for siphoning bank funds, led to the bankruptcy or technical bankruptcy of many troubled banks. The quality of the audit of these banks—with unqualified audit opinions and failure to point out infractions—made it possible to suppress these problems for several years and provoked criticism of the auditors' competence and credibility. In addition, banking supervision was inadequate. Eventually, the Government used about 13 percent of GDP in taxpayer money to restore the solvency of the banking sector.

12. **The young SKAu lacks capacity to properly regulate the audit profession.** Established in 1992, the SKAu has been trying very hard to establish itself as an effective self-regulating professional body, but lack of resources and, in particular, of the necessary expertise, constrain its ability to strengthen the audit profession. Consequently in comparison with most of the EU member countries, both the profession and the professional body in Slovakia remain at a relatively early stage of development. During the past two years, the SKAu has launched initiatives to develop a functioning structure. It has applied for membership in the IFAC and the European Federation of Accountants (FEE), and has also arranged for Scottish and French professional institutes to provide advice on organizational matters.

13. **Efforts to promote compliance with the internationally accepted ethical requirements for audit practitioners seem inadequate.** The SKAu has issued a brief Code of Professional Ethics that does not cover the detailed requirements of the IFAC Code of Ethics for Professional Accountants. At present, the SKAu does not have any effective mechanism to improve members' compliance with the code of professional ethics. For example, it is common for auditors to own shares in the companies they audit; and in many cases auditors value company assets and use the same valuation figures in the financial statements they audit.

### C. Professional Education and Training

14. **Professional education and training focus on bookkeeping and accounting.** Following the collapse of the centrally planned economy, the audit profession in Slovakia was organized by some accounting professors in higher education institutions, with the help of people who had worked as inspectors in a state control department and a state tax administration, and as chief accountants in state-owned enterprises. Drawing on their own

experience, these pioneers developed a professional examination system that mainly tested knowledge of bookkeeping and financial reporting in accordance with the requirements of Accounting Act and regulations issued by the Ministry of Finance, and did not test knowledge of modern audit procedures. The curriculum has recently been revised and the audit component expanded, but it still does not include the topics of information technology and professional ethics.

**15. Significant improvements are also needed in prequalification education and assessment of professional competence.** The entry requirement to enroll as a candidate for the professional examination is a degree in economics (equivalent to a master's degree) from a higher education institution, whether or not the degree holder took courses in accounting and auditing. A candidate must attend 200 hours of training organized by the SKAu—as described above, this system gives more emphasis to testing knowledge about bookkeeping rules and regulations than to assessing the candidate's "critical thinking" ability—and must complete three years of practical experience under the supervision of a licensed auditor. At present, the SKAu permits all of its 196 corporate members to provide this practical training; however, it has no mechanism to ensure that all of these corporate members are able to provide the kind of practical training that a modern auditor needs.

**16. There is a need to upgrade the accounting curriculum and the training of instructors.** The curriculum in higher education institutions does not give accounting students an appropriate academic background for the modern accounting and auditing profession. The institutions lack academic literature, in the local language, on accounting and auditing theories and practical application of the IASs and ISAs, and there are few well-trained instructors capable of teaching courses focusing on the IASs and ISAs.

**17. Education in professional ethics needs to be introduced.** Formal education can enhance aspiring professionals' awareness of ethical problems and can influence their reasoning and judgment with respect to ethical dilemmas. For this reason, the IFAC guideline on professional education calls for teaching professional ethics at the prequalification stage. However, in Slovakia, neither the academic institutions nor the professional body seems to be concerned that instructors of future accounting and auditing professionals should endeavor to develop in their students maturity and self-knowledge about the ethical dimensions of the profession.

**18. The requirement for continuing professional education (CPE) appears to be fine on paper, but its actual implementation is yet to be seen.** The SKAu requires its members to undertake 80 hours of CPE every two years, and to submit a statement at the end of each year regarding CPE courses taken and hours completed during the year. The SKAu has not established norms for members' participation in structured learning activities for fulfilling these CPE requirements, and has not developed a system for monitoring and enforcing the requirements.

## D. Setting Accounting and Auditing Standards

19. **The Ministry of Finance is responsible for establishing accounting regulations for all enterprises operating in Slovakia.** There is no accounting standard-setting arrangement. In addition to the general framework provided by the Act on Accounting, the Ministry of Finance's Accounting Methodology Department has issued standardized Charts of Accounts and formats for financial statements. Charts of Accounts, accompanied by detailed instructions on recording specific transactions (debiting and crediting particular account numbers), have been issued for entrepreneurial entities, budgetary entities, banks, insurance companies, small nonprofit organizations, the national property fund, the export-import bank, and municipalities. To record a transaction that is not mentioned in the Finance Ministry's instructions and for which relevant account numbers do not exist in the Chart of Accounts, an enterprise seeks guidance from the Ministry of Finance, generally proposing a method of recording the transaction in question and requesting new account numbers for this purpose. The Accounting Methodology Department reviews the proposal, approves the proposed method or provides an alternative method, and assigns new account numbers. These approved account numbers are not officially publicized for use by all other enterprises. The soundness of this method of making accounting rules depends on the ability of Ministry officials to resolve accounting issues relating to transactions that they are not familiar with.

20. **The SKAu has issued 36 Standards on Auditing (SSAs), developed by its Board of Auditing Standards.** In preparing a draft SSA, the Board reviews available professional literature, auditing standards in other European countries, recommendations issued by the European Federation of Accountants, and the ISAs issued by IFAC. It circulates the first draft of the SSA among the audit firms for comment, and then prepares a second draft and circulates it among all SKAu members for comment. At the end of the comment period, the Board prepares a final draft SSA and submits to the SKAu presidium for approval. The presidium makes a final decision about the SSA's issuance and effective date. Although the SKAu claims that all the SSAs conform to the requirements of the ISAs, there seem to be some gaps. The time and resources spent in developing SSAs could be saved by simply translating and adopting all ISAs as national auditing standards. The SKAu could use its resources better by developing implementation guidelines and an audit practice manual, which are much needed to help improve actual auditing practices in Slovakia.

## E. Ensuring Compliance with Accounting and Auditing Standards

21. **The regulatory authorities do not have any enforcement mechanism.** The Financial Markets Authority, created in November 2000, is responsible for regulating publicly traded companies; however, it does not monitor and enforce their compliance with accounting and disclosure requirements, and it does not have a plan to do so. The National Bank of Slovakia (NBS), which is responsible for regulating the banking sector, does not evince any intention to monitor and enforce banks' compliance with accounting and disclosure requirements; the NBS authorities say that enforcement is not under the purview of banking supervision but is the responsibility of the Ministry of Finance. As mentioned earlier, the tax authorities in the Ministry of Finance enforce accounting

requirements only to the extent that they affect determination of taxable profit; the Ministry of Finance does not have any other mechanism for enforcing accounting requirements. Although the Securities Act requires publicly traded companies to prepare IAS financial statements, the Bratislava Stock Exchange does not have any capacity to monitor and enforce compliance with IAS requirements. In the absence of any regulatory regime concerning appropriate use of IASs, different preparers and auditors of financial statements take different approaches in interpreting and applying the requirements.

**22. Inadequate capacity constrains the SKAu in establishing an enforcement mechanism.** Due to lack of resources, the SKAu faces difficulties in implementing an effective mechanism to monitor its members' quality control arrangements, and to take strict measures for enforcing adherence to high standards of professional conduct. It has recently entered into an arrangement with the French professional audit body, Compagnie Nationale des Commissaires aux Comptes, to receive expert assistance on developing an appropriate quality assurance mechanism. However, the operational effectiveness of such a mechanism would depend on the availability of adequately trained resource personnel in the country.

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

**23. Lack of internationally comparable accounting standards constrains foreign and domestic investment in Slovakia.** Slovakia's statutory accounting requirements produce financial statements that are intended principally to meet the information needs of the tax authorities. Preparers of such financial statements tend to focus on meeting the statutory requirements, and do not give much attention to the quality of information that does not directly affect tax computation. However, as Slovakia has been opening up to foreign investors, many of the country's large enterprises, including financial institutions, have equity and debt capital contributed by overseas strategic and institutional investors, and many overseas portfolio investors have shown an interest in investing in the domestic securities markets. These investors cannot base their investment decisions on the financial accounting information in the financial statements unless they transform local accounting numbers into internationally comparable financial accounting information (that is, consistent with the IASs)—which means incurring extra costs to do business in Slovakia. Some large enterprises and financial institutions attempt to address this problem by converting their local financial statements into a format like that of financial statements prepared according to the IASs, and they publish parts of these financial statements (generally without explanatory notes, and sometimes with the Auditor's Report), in their Annual Reports. However, even these converted financial statements fail to comply in many respects with the requirements of the IASs.

**24. There are significant differences between Slovakia's statutory accounting requirements and the IASs.** Many of the IAS requirements do not exist in Slovak accounting requirements; and even those that do may not apply to banks and other financial institutions. Some of the differences between Slovak accounting requirements and the IASs are described below.

***Presentation of financial statements.*** The Slovak disclosure requirements are very limited in comparison with the IASs, the explanatory notes are presented according to standard formats provided in the Regulation, and Income Statement and Balance Sheet figures are not cross-referenced to the notes. A Statement of Changes in Equity is not required. Banks are not required to present a Cash Flow Statement, and enterprises other than banks need to provide cash flow information in the notes to the financial statements.

***Consolidated financial statements.*** Although the IASs require full elimination of unrealized profit and loss resulting from intragroup transactions, the Finance Ministry instructions on consolidated financial statements allow “full or proportionate elimination”; and in practice, proportionate elimination is followed in most cases. The rule makers and the preparers and auditors of financial statements alike seem to be confused about the concept of consolidation. Slovakia allows reverse ownership—the parent enterprise owning shares of a subsidiary and the subsidiary owning shares of the parent—but the preparers and auditors seem to be confused about the proper way of calculating *minority interest* for presentation in the consolidated financial statements. In contrast with the IAS requirement, the Slovak regulation requires that subsidiaries with “dissimilar” activities should not be consolidated.

***Segment reporting.*** The Slovak regulation on notes to the financial statements requires disclosure of revenue by key products and territories but exempts banks from this requirement. There is no requirement, as in the IAS, to identify reportable segments—business segments and geographical segments—or to disclose detailed information about the reportable segment’s revenue, results, assets, liabilities, and so on.

***Related-party transactions.*** The Slovak disclosure requirements on related-party transactions are not as detailed as the IAS’s. The only disclosure required is the outstanding amounts, on balance sheet date, of the receivables from and payables to related parties. Moreover, contrary to the IAS requirement, related-party relationships do not need to be disclosed where control exists, irrespective of whether there have been transactions between the related parties.

***Intangible assets.*** In Slovakia, intangible assets are capitalized and amortized over a maximum period of five years. There is no requirement, as in the IAS, for determining the research phase and the development phase of internally generated intangible assets. Also, there is no requirement to include in the income statement the expenditures on intangible items that cannot be capitalized as intangible assets. The disclosure requirements for intangible assets are not fully comparable with IAS requirements.

***Impairment loss.*** Contrary to the IAS requirement, there is no need to conduct impairment tests on balance sheet date on all tangible and intangible assets to ensure that carrying value does not exceed the higher of net selling price and value in use.

**Investment property.** Slovak regulations require investment property to be carried on the balance sheet at acquisition cost less accumulated depreciation; the recognition of depreciation on investment property is conceptually inappropriate and is not allowed by IAS.

**Leases.** Slovak legislation does not define the term *lease*, and there is no IAS comparable accounting requirement for finance leases. Leased assets are not capitalized, and all lease payments are accounted for in the profit and loss account of the current year.

**Financial instruments.** The Slovak requirements on recognition, measurement, and disclosure for financial instruments are not comparable with the IAS requirements. For example, all investments in securities are carried at the lower of cost or market value, and the premium or discount arising on bonds is accounted for only on redemption; by contrast, the IAS requires all financial assets and financial liabilities to be remeasured to fair value on balance sheet date, and it does not recognize hedge accounting.

**Deferred taxation.** The Slovak requirements on deferred taxation are not compatible with those of the IAS. For example, according to Slovak regulations deferred tax assets and liabilities are created only for temporary differences relating to accounting depreciation and tax depreciation, whereas the IAS requires recognition of deferred tax assets and liabilities for all temporary differences. Moreover, the IAS requires that a deferred tax asset should be recognized for the carry forward of unused tax losses to the extent that future taxable profits will be available against which the unused tax losses can be utilized, and this is not allowed under Slovak regulations.

**Events after the balance sheet date.** Unlike the IAS requirements, the Slovak accounting requirements prohibit an enterprise from adjusting the amounts recognized in its financial statements to reflect adjusting events after the balance sheet date. Thus if any evidence contrary to the “going concern assumption” arises after the balance sheet date and before issuance of the financial statements, the financial statements cannot be changed. Slovak regulations require only that significant events after the balance sheet date, including any information concerning the going concern, should be disclosed in the notes to the financial statements.

**Additional disclosures by banks.** The Slovak accounting requirements are not compatible with IAS requirements as regards banks’ disclosures of fair valuation of each class of financial assets and liabilities; significant concentrations of assets, liabilities, and off-balance sheet items; loan-loss provisions; general banking risks, and assets pledged as security.

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

25. **The SKAu has developed 36 auditing standards based primarily on the ISAs, but it has not issued implementation guidelines.** Most practicing auditors, unless they work for an international accounting firm, do not follow an audit practice manual. Lacking knowledge about how to apply the auditing standards, many Slovak auditors do not use

them properly. This section presents information on the quality of auditing practices in Slovakia, gathered during a facilitated discussion with a group of 12 practicing auditors representing international and local audit firms in the country. Although the discussion revealed failures of compliance with almost all the auditing standards, this section focuses on selected problem areas.

***Auditor's independence.*** In the emerging market economy of Slovakia, the young auditing profession has yet to implement international best practices on auditor's independence. The auditor community seems not to fully understand the concept of auditor's independence; and without detailed guidelines, practicing auditors often fail to differentiate between the circumstances that impair an auditor's independence and those that do not.

***Quality control for audit work.*** Both international and national audit firms lack sufficient numbers of capable specialists to properly apply all the requirements of the standard on quality control. National audit firms, in particular, fall short in implementing quality control procedures in the following areas: skills and competence, delegation, acceptance and retention of clients, and monitoring.

***Documentation.*** It appears that among practicing auditors there is no common understanding of what is to be documented and how. Some knowledgeable persons stated that even when auditors perform the appropriate procedures, they may not document them in their working papers

***Fraud and error.*** The standard in this area has been reinforced by recent anticorruption legislation requiring various types of professionals in public practice, including auditors, to report fraudulent activities they may detect to the authorities. Few auditors know how to apply proper procedures for detecting fraud and error while conducting an audit exercise, and in general auditors need training to understand the essence of the standard and be able to use the fraud risk indicators.

***Audit planning.*** Many auditors in the country do not seem to have a proper understanding of the concept of audit planning, and they often conduct audits without developing an appropriate audit plan.

***Internal control system.*** Auditors tend to start with substantive testing, and often do not ask questions about internal controls and reliance on them. As a result, the managers of most enterprises are not aware of the importance of internal control systems.

***Computer information systems.*** Many large companies have installed or are installing computer information systems, but most audit firms lack the trained specialists they need for auditing in a computer information systems environment.

***Related parties.*** The Slovak auditing standard on related parties is new and is only beginning to be implemented. The generally accepted practice in the past was not

in conformity with the requirements set in this new standard. Strict application of the international best practice on auditing related-party transactions often gives rise to tension between the auditor and the client.

*Going concern.* The auditing standard on going concern is not yet being implemented: auditors have not yet started to address the issues it covers, and in general they need training and guidelines on applying it.

## V. PERCEPTION OF THE QUALITY OF FINANCIAL REPORTING

26. **Foreign investors do not view corporate financial reporting in Slovakia as being of high quality.** Interviews and discussions with a number of local and foreign investors in the country revealed serious concerns about the facts that national accounting requirements are not compatible with the IASs, and that internationally comparable auditing standards are inadequately applied in practice. Foreign banking institutions in the country often complain about the lack of transparency in audited financial statements. Investors and other knowledgeable persons in the country find that the annual financial statements issued by Slovak companies do not present and classify items consistently from period to period, and the accounting information is rarely comparable from one enterprise to another. The investor community in general finds it difficult to derive from companies' annual financial statements accurate information about contingent liabilities, related-party transactions, actual financial investments, and actual reserves. Strategic investors who have found profitable investment opportunities in the country complain that they incur additional costs in trying to overcome these problems. All of this may constrain foreign portfolio investment—the officials of the Bratislava Stock Exchange state that many foreign portfolio investors show interest in the market but then do not actually invest.

## VI. POLICY RECOMMENDATIONS

27. **The policy recommendations, presented in this section, were agreed between the World Bank staff members and the National Steering Committee (NSC).** It was also agreed that a detailed Country Action Plan (CAP) will be developed and implemented on the basis of these policy recommendations. The CAP, developed by in-country stakeholders, will be implemented under the coordination of the NSC and with assistance from international development partners. It was decided that any development program for accounting and auditing reform or development, whether carried out with the country's own resources or with assistance from international development partners, would be carried out in the context of implementing all or parts of the CAP. The members of the NSC and World Bank staff members met for three days in April 2001, to discuss various issues arising from the review of accounting and auditing practices within the ROSC initiative. The participants in the meeting agreed that the initiatives on reform and development of accounting and auditing practices in the country should be directed in the following directions:

- a) establish an effective legal and regulatory framework for accounting, auditing, and financial reporting, mainly focusing on strengthening the enforcement mechanisms;
- b) improve financial reporting practices by adopting the IASs for enterprises affecting the public interest and making accounting requirements for other enterprises converge with the IASs, and by adopting the ISAs as local auditing requirements; and take measures to ensure compliance with the established accounting and auditing requirements;
- c) develop detailed methodological guidelines on the practical application of the IASs and ISAs;
- d) take steps to introduce an internationally comparable accounting curriculum, and to develop appropriate academic literature;
- e) improve arrangements for professional education, training, and examination in line with IFAC Guidelines and UNCTAD Guidelines;
- f) provide appropriate training to strengthen the ability of enterprise accountants to prepare quality financial statements;
- g) improve corporate governance practices by introducing mandatory requirements based on the OECD Principles on Corporate Governance, and enforce these -requirements;
- h) take measures to ensure compliance with international best practices (e.g., IFAC Code and EU recommendations) on auditor's professional ethics and independence; and
- i) develop the capacity of the SKAu to function as a strong self-regulating professional body, and take steps to establish quality control and quality assurance arrangements.

28. **The policy recommendations in specific areas are briefly presented below.** A detailed program of activities in each area will be prepared at the stage of developing a detailed CAP.

#### A. Legislative and Related Reforms

- i. Submit a draft Act on Accounting to the Parliament by July-August 2002. The draft Act will be fully compatible with EU directives, regulations, and recommendations.
- ii. Submit a draft Act on Auditing to the Parliament by July-August 2002. The draft Act should be compatible with EU directives, regulations, and recommendations. Also, make statutory arrangements for adopting the IFAC Code of Ethics for Professional Accountants and EU Recommendations relating to auditor's independence and professional ethics, as mandatory requirements for the members of the SKAu.
- iii. Take necessary (legislative) steps for requiring listed companies and other financial institutions to simultaneously apply both local accounting requirements and IASs for the accounting year beginning January 1, 2003, and to apply all IASs (without modification) with effect from the accounting year beginning January 1, 2004. To facilitate the use of IASs, NSC will arrange to update the currently available

translation of “International Accounting Standards 2000,” and to translate all future IASs and SICs.

- iv. Make statutory arrangements for adopting all ISAs (without modification) as mandatory auditing standards that must be applied by all members of the SKAu (replacing existing SKAu-developed standards) with effect from January 1, 2003. The SKAu will arrange to translate all the current and future ISAs and IFAC Guidelines and Recommendations concerning audit.
- v. Introduce, by January 1, 2003, changes in the existing statutory framework for listed companies and banking institutions to reflect the OECD Principles on Corporate Governance and the Core Principles for Effective Banking Supervision issued by the Basle Committee on Banking Supervision.

#### B. Monitoring and Enforcement Mechanisms

- i. Establish effective monitoring and enforcement mechanisms in the Financial Markets Authority, the National Bank of Slovakia, the Bratislava Stock Exchange, and the SKAu.
- ii. Prepare a draft of the enforcement system for ensuring transparent financial reporting by listed companies and financial institutions.

#### C. Strengthening the Profession

- i. Improve capacity of the SKAu to properly regulate the auditing profession.
- ii. Upgrade professional examination and training arrangements for the potential members of the SKAu.
- iii. Arrange training programs for improving the expertise of existing members of the SKAu, with particular emphasis on practical application of the IASs, ISAs, and other international best practices on conducting audit activities. Also, strengthen the CPE requirements and compliance with the requirements.
- iv. Introduce organized training activities for accountants working in the corporate sector. These training programs should be first developed and delivered at the Economics University in Bratislava, and subsequently replicated in other higher education institutions throughout the country.
- v. Establish an arrangement for developing and disseminating implementation guidelines to assist in the practical application of the IASs and ISAs.

#### D. Education and Training

To introduce internationally comparable accounting education in the country, the Economics University in Bratislava and the SKAu will collaborate on the following activities in 2002.

- i. With the assistance of international experts, reform the accounting curriculum in all higher education institutions: introduce courses on the practical application of the IASs, ISAs, and auditor's professional ethics.
- ii. Organize retraining programs, taught by international experts, for selected accounting and auditing instructors of higher education institutions.
- iii. Make arrangements to develop learning materials, and for publishing books on the practical application of the IASs and ISAs.
- iv. Conduct specialized training for the officials of the tax administration and other relevant departments in the Ministry of Finance, to expose them to the practical aspects of the IASs.
- v. Organize training programs for selected groups of entrepreneurs, corporate management, government officials, and interested Members of the Parliamentary Committees on various economic matters, to expose them to the international dimensions of accounting and corporate reporting, including international best practices on corporate governance.