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REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)

ACCOUNTING AND AUDITING

UKRAINE
DECEMBER 2008

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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 Ukraine; it is an update and expansion of the World Bank's Accounting and Auditing ROSC (A&A ROSC) published in 2002. The report uses International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA) as benchmarks 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.

Corporate Sector Needs are Rapidly Evolving . The regulation of corporate sector accounting and auditing is determined by the economic context in which it operates and the structure of the market which it serves. Ukraine has a population of 46.1 million and gross domestic income (GDI) per capita of US$ 3,150 as of 2008. Since Ukraine gained independence in 1991, the Ukrainian economy has been undergoing constant transformation. Legislative, institutional and structural reforms have been driven by the rapidly changing business environment and much progress towards a market economy has been made.

The last few years have seen rapid reform: the banking sector was opened to foreign investors and owners; new sectors of the economy, such as non-banking financial institutions, have emerged; powerful national financial-industrial groups have been formed and are actively aspiring to access international markets; and an ongoing privatization program gained new momentum following the election of the new government in 2004. The Ukrainian economy now comprises a spectrum of economic subjects, ranging from large financial-industrial groups (FIGs) and banking institutions to small, privately financed enterprises. Many entities have little or no experience in using the tools offered by the market economy, but the demand for access to these tools is growing. In particular, there is increasing demand for cheaper international finance and credit which are now more readily available. This demand is led by the large entities such as the FIGs but there are signs that medium sized entities are beginning to join in order to fund necessary investment.

One necessary precondition for access to such cheaper investment finance is reliable, high quality financial information; thus, the pace and extent of Ukraine's economic reform is being held back by the widespread lack of such information. Weaknesses in accounting and auditing are a root cause of this. In the past financial information has rarely been considered a public commodity necessary to meet the needs of business, but rather a resource to which access was restricted to those having the power to require its provision. Its use in management decision-making processes has been limited by its quality and reliability and it has been often not relied upon by potential external users such as banks. Similarly, there has been little recognition that an independent audit of financial statements performed by qualified professionals could lend credibility to the financial information provided to the marketplace. Ukraine's growing economy, increased global economic integration and access to global financial markets drive the increasing demand for a greater transparency of available financial information consistent with international standards. To adequately serve the emerging need of the market and help the economy grow, the financial reporting, accounting and auditing practices in Ukraine are currently undergoing substantial change and there is a strong need to continue, and accelerate, this reform. In addition, such reform will accelerate the process of aligning Ukraine's regulatory framework with that of the European

Union in line with the Government of Ukraine's stated goals and the European Neighborhood Policy (ENP).

Accounting and Audit Reform in Ukraine. Much progress has been made since the first A&A ROSC in 2002. The legislative framework governing accounting and audit in Ukraine has recently been significantly updated; amendments to relevant legislative acts (for example the Law on Securities and the Law on Auditing) have been introduced and their implementation has been supported by some limited institutional and capacity strengthening measures. However, the laws governing, and institutions regulating, financial reporting need to continue this development if they are to conform to international standards, to meet the ever changing demands of the market and to align with the *acquis communaitaire*, the body of EU law and regulations. In addition, Ukraine continues to be significantly hampered by insufficient capacity – the number of appropriately qualified accountants and auditors in modern financial reporting standards and practices is not sufficient to serve the increasing market demand, but this situation has barely improved since the previous A&A ROSC report (2002).

One of the major effects of this weakness in accounting and auditing capacity, both institutional and in manpower, has been to restrict access to international standards-based financial reporting, and thus access to cheaper international financing, to a few companies able to procure services of the international accounting/auditing advisory companies. Four such international network accounting and auditing advisory firms have a virtual monopoly on the production of financial information conforming with IFRS. On occasions it appears that these companies may audit the same information they help to produce, as an audit by these firms can be as much a pre-requisite for access to international financing as is the IFRS-compliant financial information. Whilst there is no current requirement for statutory financial statements compliant with IFRS (IFRS-compliant statements are market driven), a recently proposed amendment to the Accounting Law will require almost 1,000 companies to use IFRS. This will require significant training and education if adoption is to be more than in name only.

The table following this summary show the progress made against the recommendations from the previous A&A ROSC in 2002. The 2002 A&A ROSC called for significant strengthening and coordination of the institutions governing financial reporting, led by the Ministry of Finance; these institutions include regulators, professional bodies and others including educators such as universities and private trainers. This strengthening has been limited. Much effort has been expended, but such efforts have lacked coordination and have not been backed by appropriate resources and access to expertise. The main lesson to be learned from the lack of progress in some areas since the previous report is the need for all the key bodies involved in the regulation of financial reporting to work together with one common aim. Tangible actions and outcomes with clearly allocated responsibilities must be identified and this must be backed up by the necessary resources, both in funding and access to national and international expertise. International development partners have a role to play in sourcing this support, but the process must be driven and owned by the Ukrainian stakeholders.

Accordingly, this A&A ROSC report makes recommendations to aid this process in accordance with international experience and good practice, and local circumstances. This is only a first step; the major challenge is to transform such recommendations into real, effective reforms that will help to enhance the quality of corporate financial reporting and deliver for Ukraine a financial reporting platform conducive to sustainable private and financial sector growth, thus improving the economic situation for all Ukraine citizens. The detailed policy recommendations are given in Section VII of this report; only a summary is given here. They address three key areas: (A) Statutory and legal framework; (B) Institutional and capacity building measures; and (C) Professional education and training.

A. Statutory and Legal Framework

The focus of the recommendations in the first area, relating to the Statutory and Legal Framework, are amendments to the Laws needed to help Ukraine's statutory framework for financial reporting be compliant with international best practice and aligned with the *acquis communautaire*, tailored to the specific current circumstances and needs of the Ukrainian economy. This report recommends that:

- All public interest entities (PIEs) be required to apply IFRS within a reasonable timeframe, not just the approximately 900 actively-traded companies as proposed by a recent amendment to the Law on Accounting.
- Small and medium sized entities (SMEs) be required to apply reduced financial reporting requirements appropriate to their nature.
- All PIEs be required to make their full audited financial statements, as part of a company annual report, publicly available in a timely manner and the accounts should be submitted to a state registry.
- The role and authority of the various regulators with regard to setting requirements, monitoring and enforcement of financial reporting be clarified in the Law on Accounting. However, the primary responsibility for the accuracy and probity of financial reporting should lie with a company's directors.
- Measures be taken to support implementation of the Law on Accounting's requirements for financial reporting, as current levels of compliance are low; these measures should include making available practical guides for major accounting items and an extensive training program for preparers of financial statements. In particular, the Ministry of Finance should lead other stakeholders in financial reporting in developing a workplan to assist first-time implementation of IFRS by public interest entities.
- Statutory auditors and audit firms to be subject to detailed registration requirements, compliance with ISA, suitable qualification criteria and submission to quality control monitoring by the Chamber of Auditors. The Chamber's role in the system of public oversight should be clarified to ensure the public interest is appropriately protected. The procedures relating to appointment, dismissal and liability of practicing auditors also need to be clarified.
- Measures be taken to assist the implementation of the new Law on Securities and the new Law on Joint Stock companies should be enacted; requirements of both laws regarding financial reporting should complement the requirements of the Law on Accounting.

B. Institutional and capacity building measures

As the economy grows, larger entities in Ukraine become more international and the requirements of financial reporting become more complex, especially in the financial sector. Recommendations in the second area, building institutional capacity and enforcing financial reporting and auditing requirements, focus on the increasing challenges that Ukraine's key regulatory institutions face. The Ministry of Finance plays the leading role in regulating financial reporting. In addition the key institutions include the Chamber of Auditors of Ukraine (CoAU), the National Bank of Ukraine (NBU), State Securities and Capital Markets Commission (SSCMC), the Commission for the Regulation of Financial Services Markets (SCRFSM) and the two major professional accountancy organizations. This report makes recommendations for measures to enhance institutional capacity to enable the effective implementation and enforcement of ongoing reform. These include:

- There is a consistent need for institutional and capacity building measures at each institution responsible for financial reporting. The plans are likely to include capacity building measures including twinning or secondments with or to international organizations with similar roles as well as training and recruitment of personnel with international accounting and auditing experience and qualifications. Also, sustainable funding mechanisms should be developed to ensure that each institution can effectively discharge its functions.
- That an efficient and sustainable translation process for the latest IFRS, ISA and the IFAC Code of Ethics be established to make the official translations readily available and affordable across Ukraine.
- That the regulatory framework is improved to reduce the mandate of the SSCMC. Currently its remit of over 35,000 companies is too large to allow it to fulfill its responsibilities and role effectively. However, the SSCMC remit should be extended to make it explicitly responsible for reviewing the appropriateness of accounting policies adopted by regulated entities, and the compliance of entities with those accounting policies and the applicable financial reporting standards.
- That the CoAU implement measures to improve the quality of statutory audit and compliance with ISA. Measures should include: updating the CoAU's Audit Manual and Methodology to be compliant with the latest ISAs; designing sector-specific audit methodologies; further developing and implementing comprehensive audit quality assurance; and establishing an effective system of investigations, conflict resolution and sanctions for misconduct related to statutory audit.
- That the NBU seek to increase cooperation between commercial banks' independent auditors and its supervision department.
- That the NBU, SSCMC and SCRFSM develop and implement risk assessment systems and adopt risk-based supervision processes. This will allow them to focus limited resource more effectively on issues of public interest. Accordingly, their enforcement capacity needs to be strengthened, enabling the regulators timely and effectively address noted infringements.
- That the professional accountancy organizations (UUOA, UFPAA and UACAA) should introduce a joint strategy of development for the accountancy profession in Ukraine which assesses and clearly identifies the resources needed to achieve the set objectives; they should seek to represent and, eventually, include in membership the wider accountancy profession in Ukraine.

C. Professional education and training

The third area, enhancing academic education, professional training, and 'retooling' of accountants focuses on the strong need to improve the capacity of the accounting and auditing professions. The genuine understanding and adoption of new accounting, financial reporting and auditing standards and requirements requires relevant education and training for financial statement preparers, auditors, and regulators. In this regard, it is essential to enhance the capacity of existing accountants as well as ensure the capacity of future accountants. Proposed measures include:

- A major program to re-tool existing accountants in Ukraine. 'Chief accountants' and others responsible for preparing financial statements should be encouraged and incentivized to improve their understanding of modern accounting, including IFRS, NAS and relevant laws and regulations.
- The Government of Ukraine, regulators, professional organizations, academia and other policymakers should establish defined levels of recognized qualification which all accountants could aspire to and which would be affordable, within their capabilities and not require fluent English. The CAP qualification is a useful first stage qualification available in the Russian language which could potentially be a prerequisite for accounting positions in government departments, regulators, PIEs and academia and a prerequisite for auditors. In the longer term, a Ukrainian-language qualification should be developed.
- Accounting syllabi, curricula and university courses should be updated and redesigned to effectively teach IFRS, NAS and the key principles of their application in Ukraine.
- University and business school faculties should be suitably resourced, both with appropriately trained and skilled staff and with adequate teaching materials, including up-to-date textbooks, course materials and reference materials such as local-language copies of IFRS, ISA, NAS etc.
- Professional certification programs operated by CoAU, UUOA, UFPAA, and UACAA should be reviewed to ensure that they comply with International Education Standards (IES).
- The professional organizations' Continuous Professional Development (CPD) requirements should comply with IFAC requirements.

From Recommendations to Reform. These recommendations require a holistic, multi-disciplinary approach and should be implemented as soon as possible following the publication of this report. Such implementation will require the cooperation of a wide range of stakeholder groups including the Government, regulators and the accountancy profession, and should be championed by a senior Government figure.

Ukraine should establish a multidisciplinary National Steering Committee (NSC) to coordinate the above accounting and auditing reforms. The NSC should advise policymakers and regulators regarding the implementation of the recommendations. Based on the successful experience of other countries, this report recommends that the NSC develop a Country Strategy and a detailed Country Action Plan which clearly sets out the key actions and allocates responsibilities for implementing the necessary reforms.

Table 1: Progress since 2002 on Key Recommendations of the Previous A&A ROSC

Recommendation from 2002 A&A ROSC	**Achieved/ not achieved**	**Comments**
1. Requirements for general purpose financial reporting to be differentiated from reporting for taxation purposes.	Mostly Achieved	The legal basis is now clearly differentiated, although in practice, reporting for taxation purposes often dominates.
2. Number of companies required to have a statutory audit to be reduced	Not Achieved	The current audit requirement still includes large number of corporate entities
3. Conflicts between regulatory and general purpose (IFRS) reporting for banks to be eliminated	Partly Achieved	Some key conflicts, such as reporting of ultimate beneficial ownership and related party transactions, remain
4. Non-banking financial institution regulator to be established	Achieved	The SCRFSM is established.
5. Due process for drafting Ukrainian National Accounting Standards to be established and issuing body capacity to be strengthened	Mostly achieved	The MoF, with the AMC, has a due process for drafting and issuing NAS; capcity could be further strengthened
6. ISA to be adopted	Achieved	CoAU adopted ISA, though application is a challenge
7. Securities Commission to reduce the number of entities it regulates to focus on those with securities	Not achieved	Recommendations is repeated in this report, to reduced the mandate of the SSCMC
8. Publication requirements to be rationalized	Not achieved	Public availability of financial information is extremely limited
9. CoAU to upgrade training and eductation for auditors	Partly achieved	Further strengthtening of audit qualification and CPD requirements in line with IFAC guidelines could be beneficial

This report was prepared on the basis of the findings from a diagnostic review carried out in Ukraine by a team from the World Bank. The team was led by Jon Hooper and Svetlana Klimenko and comprised Irina Babich (World Bank, Kiev), Leo Asmanis (Bank of Latvia), Debbie Crawshawe (Financial Reporting Council, United Kingdom), Edward McEntee (Helm Consultants, Ireland) and John O'Donnell (Financial Services Authority, Ireland). Jan Tyl and Andrei Busuioc (ECAAT) contributed to the finalization of the report. The review was conducted through a participatory process involving various stakeholders and led by the country authorities

Table 2: A&A ROSC 2008 Policy Recommendations

ACCOUNTING AND AUDITING ROSC POLICY RECOMMENDATIONS

	Statutory	Accounting	Auditing	Monitoring and Enforcement	Accounting and Audit Profession	Education
SHORT TERM	1 Require all public interest entities to apply IFRS and make audited financial statements publicly available 2. Statutory auditors to have detailed registration requirements			1. The SSCMC's mandate to be reviewed		1. Accounting and auditing professional qualification syllabi to be reviewed for compliance with IFAC's International Education Standards 2. CPD requirements for professional organizations to comply with IFAC guidelines
MEDIUM TERM	3. SMEs to be subject to reduced reporting requirements appropriate to their size and nature 4. Establish public oversight of the Chamber of Auditors of Ukraine	1. Establish sustainable translation process for IFRS 2. Roles of each regulator with regard to setting, monitoring and enforcing financial reporting requirements be clarified in the Law	CoAU to: 1. Establish sustainable translation process for ISA and IFAC Code of Ethics 2. Maintaining an ISA-compliant standard audit methodology and Audit Manual 3. Make available training courses in the implementation of the standard methodology and Audit Manual	2. NBU, SSCMC and SCRFSM to adopt risk-based supervision 3. CoAU to further develop external quality assurance of the audit profession linked to registration and to introduce complaints, investigations and disciplinary systems 4. NBU to increase cooperation with banks' independent auditors	1. CoAU to establish an electronic register of statutory auditors 2. Professional associations to set clear strategy to seek to include a wider proportion of Ukrainian accountants within the organized profession	3. All stakeholders to establish recognized levels of qualification and promote training for 'chief accountants' and others 4. Major program to re-tool accountants responsible for preparing financial statements in Ukraine 5. University syllabi in accounting to be updated and faculties to be appropriately resourced and staffed
LONG TERM				5. Enhance capacity of supervisory authorities via training, recruitment, secondment and twinning		6. Professional organizations to work closely with universities to allow exemptions from early-stage professional examinations

critical success factors

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MAIN ABBREVIATIONS AND ACRONYMS

ACCA	Association of Chartered Certified Accountants
BCBS	Basel Committee on Banking Supervision
CAP	Certified Accounting Practitioner
CIPA	Certified International Professional Accountant
CPD	Continuing Professional Development
CoAU	The Chamber of Auditors of Ukraine
EU	European Union
GDI	Gross Domestic Income
FIG	Financial Industrial Group
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 (included in IFRS)
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IES	International Education Standard
IESBA	International Ethics Standards Board for Accountants
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards (including IAS)
IMF	International Monetary Fund
ISA	International Standards on Auditing
ISQC	International Standards on Quality Control
JSC	Joint stock company
LLC	Limited liability company
MoF	Ministry of Finance
NAS	National Accounting Standards
NBFIs	Non-Banking Financial Institutions
NBU	National Bank of Ukraine
NSPF	Non-State Pension Fund
PIE	Public Interest Entity
ROSC	Reports on the Observance and Standards of Codes
SCRFSM	State Commission for Regulation of Financial Services Markets
SSCMC	State Securities and Capital Markets Commission
SME	Small and Medium-Sized Enterprises
SMO	Statement of Membership Obligations of IFAC
SOE	State Owned Enterprise
UACAA	Ukraine Association of Certified Accountants and Auditors
UFPAA	Ukrainian Federation of Professional Accountants and Auditors
UUOA	Ukrainian Union of Auditors
USAID	United States Agency for International Development
WTO	World Trade Organization

I. INTRODUCTION

1. This assessment of accounting and auditing practices in Ukraine 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 includes both a review of both mandatory requirements and actual practice. The report 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. Ukraine has a population of 46.1 million and gross domestic income (GDI) per capita of US$3,150 as of 2008.[3] After eight years of decline following independence, the Ukrainian economy began growing in late 1999 and has been growing steadily since with the exception of 2005, when political uncertainties resulted in lowered economic growth and decreased investor confidence. The stabilization of the political situation in 2006 coincided with robust economic expansion, with cumulative growth rising to an estimated 7% by the end of 2006.[4] The improvement was driven by both favorable external conditions which boosted demand for the main export-oriented industries such as metallurgy and strong domestic demand driven by earnings growth, rising investment and expanding credit.

3. In the last 16 years of independent development, Ukraine has developed many characteristics of a free market economy - it has liberalized its markets, reduced regulation, eliminated most restrictions on foreign currency exchange and initiated fundamental restructuring of the legal system. Following periods of hyperinflation the national currency, the Hryvna, has been stable against the US dollar for over five years, supporting smooth and uninterrupted growth and strengthening investors' confidence. However, further structural reforms, deregulation and legal system modifications remain to be completed and require the continuous commitment and support of the Ukrainian government. These priorities are reflected in the EU-Ukraine Action Plan, and were reflected in the WTO accession plan (Ukraine joined the WTO in May 2008).

4. Privatization is an important part of the Ukrainian government's domestic policy, as well as one of the significant sources of income for the state. Mass privatization of small- and medium-sized enterprises was completed in 1999, however there remain some significant State-Owned Enterprises (SOE) in such strategic sectors such as telecommunications and utilities. The privatization process continues, with significant proceeds raised from privatizations in 2005. However, in some sectors weak regulatory controls and institutional frameworks, together with a lack of high-quality financial information compliant with international standards have been major

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1 International Financial Reporting Standards are issued by the International Accounting Standards Board, an independent accounting standard-setter based in London, United Kingdom. In April 2001, the IASB announced that it would adopt all of the International Accounting Standards issued by the International Accounting Standards Committee . For simplicity's sake, the term IFRS will include IFRS, IAS and IFRIC interpretations in this report.

2 International Standards on Auditing (ISA) are the standards issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants and include the International Standards on Quality Control and International Auditing Practice Statements.

3 World Bank staff calculations, Atlas method.

4 Estimated GDP for 2006. Economist Intelligence Unit: Country Report.

impediments to further privatization which has contributed to the shortfall against the Government's target for privatization proceeds in 2006.[5]

5. The banking system represents the most stable and advanced component of the country's financial sector. During the last decade, the banking sector in Ukraine has exhibited high growth and was the most dynamic and leading sector in the country. Over the past two years the total stock of credit assets and deposit liabilities in the banking system has more than doubled in nominal terms. Competition in the banking sector is increasing and a recent wave of major acquisitions by foreign banks suggests that foreign capital has particular interest in entering this sector. As of August 2006, the share of foreign ownership in the Ukrainian banking sector was approaching 30% and an amendment to the law on banks and banking activities in November 2006 allows foreign banks to open branches in Ukraine. Another recent amendment requires all new entrants in the banking sector to have a minimum statutory capital of €10m which prevents the emergence of small banks, particularly the so-called pocket banks that have been a feature of Ukraine's banking sector since independence.

6. The non-banking financial sector is undergoing significant transformation; however, it still lags significantly behind the banking sector.[6] Legislative improvements in the area of financial leasing, insurance, non-state pension funds, and mortgage finance have encouraged the development of new financial services and fast growth of non-banking financial sector, led by the insurance companies, which remain its core. In 2005 insurance premiums were equivalent to 5 percent of GDP, a reduction from the 2004 level.[7] This decrease resulted in part from the government's restriction on the insurance premiums which could be counted as a legitimate expense, as much evidence suggested that domestic enterprises used pseudo-'insurance companies' to avoid taxation. A recently adopted amendment to the insurance law will allow foreign insurers to perform certain activities in Ukraine; this law became effective upon Ukraine's accession to the WTO.

7. Until January 2004, the State was the sole provider of formal pensions, and non-State pension funds developed without adequate regulation and supervision. New pension legislation enacted in 2004 covers mandatory state pension insurance and non-state pension insurance. Together with the framework law on mutual funds approved in 2001, these laws pave the way for more developed investment institutions to emerge. However, a major part of the few current non-state pension funds is kept in bank deposits, with only small share going to the securities market (overwhelmingly corporate bonds). There has been slow progress in developing the regulatory infrastructure needed for pension and mutual funds to operate effectively.

8. Notwithstanding rapid growth in the major market indices in recent years, Ukraine's securities market remains weak and inefficient. Set up originally to facilitate post-privatization enterprise restructuring in the 1990s, the country's stock market is still dominated by buyers of enterprises as a whole rather than frequent transactions of small numbers of shares. Brokerages

5 With no significant assets on offer, total privatization earnings reached HRN350m in January-October, equal to just one-sixth of the HRN 2.1bn target for 2006 as a whole (based on the EIU country analysis).

6 For more information about the non-banking financial sector in Ukraine see *The Development of Non-bank Financial Institutions in Ukraine. Policy Reform Strategy and Action Plan*, World Bank, 2005.

7 USAID Capital Markets Project, CMP/CASE Ukraine: First Quarter 2006 Macroeconomic and Financial Sector Development.

continue to operate on their own money, and the number of classic portfolio investors (particularly non-resident investors) remains limited. As shares in some of the most attractive assets either do not float freely (as in the case of Kryvorizhstal) or else only in limited number (as in the case of Ukrtelecom), trading is generally sporadic and low-volume. The securities market has also suffered from an underdeveloped legal and regulatory infrastructure. The 1991 framework law on securities was only updated in February 2006. The new law tightens licensing requirements for professional market participants by raising the minimum capital requirements for dealers and brokers.

9. The industrial sector contributes a significant share of Ukraine's GDP.[8] The country is a major center for mining, metallurgy, heavy machinery and industrial equipment production. A large share of industrial output is produced by enterprises controlled by financial-industrial groups (FIGs). First formed in the late 90s, these business conglomerates have gained particular prominence in recent years. These groups have been characterized by non-transparent ownership, legal and property structure and weak corporate governance. Such groups often include a powerful bank capable of carrying out the functions of cash generator within a group, a high degree of business diversification and a high concentration of property assets. In the past the FIGs were not considered to have an international focus or to be active users of innovations; however some FIGs have recently shown increasing interest in international financial markets, corporate restructuring and, though slight, moving towards improved transparency.

10. All the key economic sectors in Ukraine rely on high quality financial information, which requires high quality private sector accounting and auditing. As Ukraine moves towards further reforms, liberalization and deregulation in efforts to foster an investment-friendly business environment, enhanced financial transparency and improved accounting and auditing practices must support this. Increased levels of both foreign direct investment (FDI) and domestic investment demand a higher quality of financial information consistent with international standards. Continuing the strengthening and development of financial reporting, accounting and auditing, and the regulatory framework that governs them, will bring benefits to Ukraine and its citizens. In this context, this report sets out 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 the market economy.

8 The 2008 share of industry in total GDP reached 36.2% (World Bank staff calculations based on SSCU's data).

II. THE INSTITUTIONAL FRAMEWORK FOR ACCOUNTING AND AUDITING[9]

A. The Statutory framework for financial reporting, accounting and auditing

11. **Since it gained independence in 1991, Ukraine has adopted a civil law system based on codes and acts.** The Law on Companies (1992), and the Civil and Commercial Codes (2004) define various legal structures which can be used by businesses operating in Ukraine. The most commonly used types of legal entities include joint-stock companies, (which can be open joint-stock companies or closed joint-stock companies), limited liability companies, additional liability companies, general and limited partnerships[10]. The most common are limited liability companies and joint-stock companies. Enterprises with foreign capital are generally established in the form of joint-stock companies or limited liability companies, or operated through representative offices.

12. **Responsibility for financial reporting at limited liability companies and joint-stock companies is set out in the Law on Companies.** In both, the Management Board and/or the General Directorate are responsible for the day-to-day activities of the company, including accounting and financial reporting. In addition there is a Supervisory Board, which is roughly equivalent to a Board of Directors in Anglo-Saxon jurisdictions. For joint-stock companies, there is a legal requirement for a Revision Commission, a body with certain oversight responsibilities. However, the Revision Commission does not fulfill many of the necessary functions of an ‘Audit Committee’, such as the approval of the appointment of independent auditors and the review of the audit report. Company legislation should be amended to either replace the Revision Committee, or significantly amend its structure, composition, role and responsibilities, to require that companies have an audit committee in accordance with international best practice. Banking legislation already requires this for banks; the requirement should be extended to all joint-stock companies. .

A.1. The Statutory Framework for Accounting and Financial Reporting

13. **Accounting and financial reporting requirements for enterprises in Ukraine are regulated by the Law on Accounting and Financial Reporting (Law on Accounting) which came into effect on January 1, 2000.** The Law on Accounting introduced new National Accounting Standards (NAS), which are required to ‘not contradict’ International Accounting Standards. According to the Law on Accounting, the development and implementation of accounting and financial reporting methodology are regulated by the Ministry of Finance (MoF), which approves the NAS[11] and other regulatory acts with respect to general accounting and financial reporting. The Law on Accounting also lists the State Securities and Capital Markets Commission (SSCMC) and the National Bank of Ukraine (NBU) as regulators able to set specific reporting requirements for their regulated entities. The State Commission for Regulation of

[9] 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.

[10] A recent amendment to the Banking Law requires banks to be founded as, or convert to, open join-stock companies.

[11] Approval and adoption of the NAS is based on recommendations received from the Accounting Methodology Council, the consultative expert body established by the MoF. The Council includes practicing accountants, auditors, representatives of public organizations, academia and state bodies.

Financial Services Markets (SCRFSM) was created only in 2002 and is not officially defined as one of the regulators in the Law on Accounting; however it also sets financial reporting requirements for its regulated entities.

14. **The Law on Accounting states that financial statements should provide users with complete, fair, and unbiased information about the financial position, results of operations and cash flow of an entity.** Amongst other things it requires:

- Each entity to prepare a financial report including a balance sheet, statement of financial results, cash flow statement, equity statement and notes to financial statements. For small entities[12] and representations of foreign companies only a balance sheet and statement of financial results is required.
- The proprietor or company directors to accept responsibility for the accounting arrangements and records of the entity.
- Parent entities owning subsidiaries to present consolidated financial statements in addition to stand-alone financial information.
- Enterprises to submit quarterly and annual reports to the authorities having jurisdiction over these enterprises.[13]
- Certain entities to make their financial reports publicly available (through publication in the media and other official channels).[14] These include public joints stock companies, enterprises issuing bonds, banks, trust partnerships, currency and stock exchanges, investment funds and companies, credit unions, non-governmental pension funds, insurance companies and other financial institutions.

15. **The Ministry of Finance has recently proposed an amendment to Article 14 of the Accounting Law which will require companies with actively traded securities or bonds to use international standards (IFRS) in the preparation of their financial statements; there are currently approximately 900 companies which will be required to use IFRS under this proposed amendment.** The amendment will also require all open joint stock companies, issuers of bonds, professional participants of the securities market, banks, insurers, non-government pension institutions and other financial institutions to make public their financial statements and consolidated financial statements, together with the auditor's report, not later than June 1 of the year following the reporting period, by publishing in periodicals, distributing as separate printed publications and/or posting on the internet. There is no single public registry of financial

[12] Ukraine legislation, as amended by the Law 523-VI of September 18, 2008, defines small entities as entities with the number of employees not exceeding 50, and annual turnover not exceeding 70 mln HRN (~7 mln. EUR); while medium entities – turnover 70-100 mln. HRN (~7-10 mln. EUR), and number of employees 50-200. The asset value is not used as a criterion to measure the size of an entity. As an example, the European Fourth Company Law Directive, as modified, defines small and medium sized entities as those entities which, on their balance sheet date do not exceed the limits of two of the three following criteria (the Member States can establish lower criteria suitable to the circumstances of the economy):

	Small	**Medium**
Balance sheet total	**€4,400,000**	**€17,500,000**
Net turnover	**€8,800,000**	**€35,000,000**
Average number of employees during the financial year	**50**	**250**

[13] These include various controlling authorities, i.e. sectoral ministries, which may set specific requirements to the content of the presented financial information, in addition to the rules set by the MoF.

[14] The Law on Accounting requires such information to be published not later than June 1 of the following year.

statements at present so it is unclear how this requirement to make financial statements publicly available will function effectively; publishing in periodicals is impractical given the length of IFRS-compliant financial statements of which the notes to the financial statements are an integral part. The amendment has been voted on in parliament on several occasions; however, has not been approved.

16. **The Joint-Stock Companies Law, as amended in September 2008 (effective since April 2009) lays down that a JSC may be public[15] or private. Art 40 of this law requires that public JSCs shall, additionally to NAS disclosures, disclose information on their operations based on international accounting standards, according to the procedure established by the Securities and Stock Market State Commission.** These amendments raise several issues: (i) the definition of public JSCs does not take into consideration whether the company is listed (i.e. with actively traded securities) or its size; this creates a possibility that some small companies that in fact do not represent public interest entities, will be in this group; (ii) the IAS disclosures are required in addition to NAS, which creates an additional burden to the companies; and (iii) there is no reference as to which IASs should be followed; currently IASs are part of IFRS and in order to make them enforceable, an official translation should be adopted in Ukraine.

The following table summarises the financial reporting requirements for entities in Ukraine:

[15] Public JSCs should have more then 100 shareholders and can issue securities publicly or have private placements, while private JSC should have less then 100 shareholders and can have only private placements of securities (i.e. only to a closed group of shareholders/owners).

Table 3: Corporate Financial Reporting Requirements

Financial statements / Entities	Legal Entity and Consolidated Financial Statements
Public Joint-stock companies	Currently required to use Ukrainian National Accounting Standards. The amendments to the JSC law effective from April 2009, requires that these companies shall, additionally, disclose information on their operations based on international accounting standards, according to the procedure established by the Securities and Stock Market State Commission. Under the proposed amendment to the Law on Accounting, these companies will be required to report in accordance with IFRS.
Private joint-stock companies (with less then 100 shareholders and with only private placement of securities)	Accounting and reporting in accordance with Ukrainian National Accounting Standards. Under the proposed amendment to the Law on Accounting, these companies *may choose to* report in accordance with IFRS.
Private limited liability companies	Accounting and reporting in accordance with Ukrainian National Accounting Standards
Banks	Accounting and reporting in accordance with NBU requirements and regulations, which nominally require the use of IFRS but have some key and important exceptions to IFRS (see Section III). Under the proposed amendment to the Law on Accounting, banks will be required to report in accordance with IFRS.
Non-banking financial institutions (NBFIs)	Accounting and reporting in accordance with Ukrainian National Accounting Standards, subject to any further accounting requirements set by the SCRFSM, the NBFI regulator. Under the proposed amendment to the Law on Accounting, these institutions *may choose to* report in accordance with IFRS.
Insurance companies	Currently required to use Ukrainian National Accounting Standards. Under the proposed amendment to the Law on Accounting, these companies will be required to report in accordance with IFRS.

17. **Provisions contained in the Law on Accounting and NASs are further explained and clarified in the methodological materials published by the MoF, and other authorized agents, (e.g. banking regulators, various ministries and committees,). Unfortunately, some such supporting materials have been developed independently and are fragmented and uncoordinated.** For example, NAS were introduced a few years ago and seven implementation guidelines have been or will be completed; however, these guidelines do not fully address the difficulties many accountants encounter to apply the NAS properly.

18. **The SSCMC is the main regulator for all issuers of securities, debentures and bearer bonds.** The Law of Ukraine on Securities and Stock Markets (Securities Law), adopted in February 2006, governs the placement and circulation of securities and the exercise of professional activities on the stock market. Many parts of this new law are based on EU Directives and cover financial reporting for regulated entities. The law requires quarterly, half yearly and annual reporting; the disclosure of major shareholdings (a significant issue in Ukraine); the disclosure of issuer specific information and insider information; and publication of

financial information (annual information, including financial statements and audit opinion, has to be published in one of the official newspapers not later than April 30 of the year following the reporting year (being 4 months after the year end) - this represents a significant improvement of the previously existing September 30 (9 months after the year end) deadline).

19. **As mentioned above, publishing financial statements, including notes, in newspapers is not practical; it is not clear how companies will comply with the publishing requirement.** In an attempt to address this issue, PFTS, the leading stock exchange in Ukraine representing approximately 90% of total trading volumes, recently launched a publicly available web-site, making issuers' information available to a large audience.[16] Periodical financial information, voluntarily contributed by the companies-issuers, is part of this public disclosure. The public availability of financial information should be coordinated through a central regulated registry for all companies required to publish their financial statements. In addition, the annual reports of issuers should be made available by the SSCMC on their website.

20. **The Securities Law also sets out requirements for the SSCMC to review and approve prospectuses prepared by the entities issuing securities[17].** By approving the document, the SSCMC accepts responsibility for the completeness of the information contained in the document (including financial information) and its conformity with the legislation. The placing of responsibility on the Commission for the completeness of information could be seen to inhibit the general requirement for companies and directors to be responsible for financial information issued by a company.

21. **The National Bank of Ukraine (NBU) is responsible for the development and implementation of accounting and financial reporting requirements applicable to the banking sector.** The Law of Ukraine on Banks and Banking Activity (the Banking Law) requires banks to perform accounting to comply with the rules and regulations established by the NBU, which should be in accordance with IFRS and relevant regulations of Ukraine. The NBU has developed detailed instructions for the format and disclosures of banks' financial statements and established accounting regulations for key areas of banking activity. However, despite the Banking Law making specific reference to IFRS, the rules and regulations issued by the NBU have not covered all aspects of IFRS (in particular regarding related party transactions and ultimate beneficial ownership) and have not been updated to include recent changes to IFRS, especially those since 2005. The NBU's regulations (and thus the banks' financial statements) cannot be considered to be fully compliant with IFRS.

22. **Banks are obliged to provide their entity financial statements, together with certain information about affiliated entities, to the NBU so that the NBU can evaluate their financial condition.** In addition, every legal entity which has an significant participation in the bank is obliged to submit its annual report, including financial statements, to the NBU. The NBU has the right to request the banks' consolidated financial statements. Annual audited financial statements and quarterly financial statements of the banks have to be published in the designated

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16 This project used software donated to the PFTS by USAID.

17 The SSCMC is currently updating regulation on the preparation of prospectuses and registration of issued securities. The previously existing regulation required entities issuing securities to present a complete set of their financial information and an external auditor opinion as part of the prospectus.

official newspapers.[18] Due to the significant size of the financial statements, the NBU has limited this requirement to partial financial statements, excluding notes. However, the banks are required to disclose where a full copy of financial statements can be obtained.[19]

23. **The State Commission for Regulation of Financial Services Markets in Ukraine (SCRFSM) was established in December 2002 to supervise non-banking financial institutions (NBFIs), including pension and investment funds, insurance companies, credit unions and leasing entities.** The SCRFSM requires NBFIs to submit financial statements prepared in accordance with NASs approved by the MoF. In addition, the SCRFSM requires NBFIs to make regulatory reports covering such information as premiums and claims analysed by class of insurance, liquidity of assets, solvency of balance sheet, reinsurance premiums and a range of other data analysed in greater detail than in any financial statements prepared under IFRS.[20] According to the requirements of the Accounting Law, NBFIs' annual financial statements have to be published in the official newspapers (see above).

24. **The NBFI sector, including the regulator, is relatively new. The main difficulty faced by the sector's accounting professionals is the lack of a comprehensive, sector-specific accounting and financial reporting methodology, which could be applied in practice.** Generic NASs (and in some areas such as insurance accounting, IFRS) are poorly equipped for this purpose. An example of this is methodological recommendations issued in December 2004 by the SCRFSM on accounting of major operations of non-State pension funds, which aim to harmonize accounting policy and methodology of non-state pension funds. In addition, the SCRFSM issues regulations regarding professional requirements of managers and chief accountants of financial institutions which provide for standards of education, experience and probity for managers and chief accountants of financial institutions. These require such managers and accountants to have the necessary qualifications, skills and experience to perform the duties of that position. This is a similar concept to how financial services regulators such as the UK's FSA have 'regulated individuals' for certain roles such as 'money laundering officer'. However, directly regulating managers and accountants goes further than most comparable regulation.

25. **There is a significant number of major State-Owned Enterprises (SOEs) in Ukraine primarily concentrated in strategic sectors such as telecommunications, utilities, mining and manufacturing.** These enterprises are often joint-stock companies and thus follow the requirements of the Law on Accounting and use NAS to prepare their financial statements. In addition, these enterprises follow the "Statute of the Accounting Procedure for Certain Assets and Operations of the State and Utilities Sectors of the Economy which Use State or Civic Property," and often are required to prepare separate reports for various governmental authorities, including the State Statistics Committee, their respective ministries, social funds, tax authorities, etc. Many of the SOEs have rudimentary accounting systems and lack capacity in preparing financial reports, especially well-trained professional accountants. As a result, they experience significant

18 Banks have to publish their quarterly balance sheets and profit and loss accounts during the month following the reporting quarter. Annual audited financial statements have to be published before June 1 of the year following the reporting year.

19 Copies of 'full' financial statements are usually available upon request at the premises of the bank and, in the case of larger banks, are often published on their websites.

20 Quarterly financial information has to be submitted to the SCRFSM not later than 25th of the month following the end of the quarter and annual financial statements have to be submitted not later than 20th of February following the reporting year end.

difficulties in applying NAS and the quality of the financial information produced by the SOEs varies significantly. The variable quality of financial information, which often inadequately reflects the financial and economic performance of the entity, becomes particularly restrictive when the Government seeks to privatize the entity or the entity seeks other sources of external financing.

26. **The importance of the tax authorities as one of the influences on accounting and auditing practices is decreasing in Ukraine as demand for financial statements from other sources increases (e.g. demand from banks and other finance providers, shareholders, potential investors).** However, consistent anecdotal evidence and the outcome of the financial statement review in section III both indicate that many preparers of financial statements struggle to understand the key differences between general purpose accounting under NAS or IFRS and accounting for taxation purposes. Often the ‘tax numbers’ are simply inserted into a standard chart of accounts to produce the general purpose financial statements. One reason for this is that, in the past, entities were required to present their financial statements while submitting annual tax declarations and many believed (perhaps accurately) that dissimilar information in the financial statements from the taxation return would be treated as suspicious or even illegal by tax authorities. Whilst tax authorities no longer require submission of the financial statements as a matter of course, they still have access to entities’ financial statements and underlying financial records during tax audits. There exists in Ukraine, as in many peer countries, confusion amongst practicing accountants who still view tax accounting as the primary purpose for preparing accounts and often lack a clear understanding of the differences in requirements of NAS or IFRS as against taxation regulations.

27. **Small and Medium Enterprises (SMEs) established under the Ukrainian law follow the requirements of the Law on Accounting and apply NAS.** As noted above, small entities are allowed to prepare condensed financial information consisting solely of the balance sheet and statement of financial results (i.e. following requirements of NAS for small entities), while medium entities have to apply full NAS. For many SMEs (i.e. non-PIEs) compliance with even reduced financial reporting requirements is a significant challenge. Very few SMEs are incorporated as Joint Stock Companies and thus external demand for their financial information is often limited to the requirement to submit annual financial information to the State Statistics Committee and as a basis for calculating taxation (though they are now not required to submit their statements with the tax returns). Moreover, with concentrated ownership and limited access to external financing, the requirement to produce comprehensive financial information is often perceived as unnecessarily burdensome. NAS, based on IFRS and designed to not contradict IFRS, are complex. Similarly to IFRS, NAS may not be appropriate to the needs of SMEs and they are often not applied properly. To ease the administrative burden on SMEs, the MoF may wish to consider drafting a NAS Standards for SMEs’ (or transform existing NAS to satisfy the needs of non-PIEs, but which would not be applicable to micro-entities) which sets out accounting requirements appropriate to SMEs in Ukraine. Furthermore, it may be useful to explore the possibility of even more simple requirements, e.g. income tax reporting only, for micro-entities.

A.2. The Statutory Framework for Auditing

28. **The regulation of audit in Ukraine has recently been updated with the introduction of a new Law on Audit Activity in December 2006 (the 'Audit Law').[21]** The new Law represents a significant step towards the adoption of international practices; it confirmed ISA as the national auditing standards (adopted by the CoAU in 2003), clarified and extended provisions related to the regulation of the audit profession and redefined the role and responsibilities of the Chamber of Auditors of Ukraine. However, as discussed below, significant challenges remain in implementing the Law and enforcing the auditing standards.

29. **The requirement for statutory audit defined in the Audit Law makes reference to the financial reporting framework detailed in Section A.1 above.** Article 8 of the Law requires that open joint-stock companies, issuers of securities, professional participants of the stock exchange, financial organizations and other entities falling within the categories obliged to make their financial reports publicly available are required to have their entity and consolidated financial statements audited. The statutory audit requirement also applies to companies with foreign investments, insurance and holding companies, investment funds, trust institutions and other financial intermediaries. This requirement for statutory audit is different from the EU audit requirement, which requires all companies with limited liability to be audited but permits member states to exempt small companies from the requirement to have an audit. The EU sets maximum limits on the size criteria for 'small' companies but member states can set smaller size criteria if appropriate for their state. Given the limited current capacity of the audit profession in Ukraine, the statutory audit requirement should be limited to those companies in which there is a public interest in there being an audit.

30. **The Audit Law permits auditors to provide certain "other audit services". Article 3 of the Law defines such services as including "consultations on accounting, accountability, taxation, analysis of financial-economic activity and other types of economic and legal provisions for business undertaking for physical and legal persons".** The inclusion of these services in "other audit services" is not appropriate as they do not result in providing audit opinion / assurance. Further, a clarification would be useful to indicate the circumstances in which provision of these services may result in a threat to independence.

31. **As mentioned above, there is no general requirement in Ukraine Law for the approval of the appointment of independent auditors and the review of the independent audit report by the entity shareholders, supervisory board or audit committee.** The only exceptions to this rule are banking institutions.[22] The auditors currently address the report to those with whom they have directly contracted (i.e. the Board of Directors, who are also responsible for the preparation of the financial statements).[23] This close relationship between the independent auditor and the client, in terms of appointment and submission of reports, creates a threat to independence of the auditor and diminishes the reliance other stakeholders can place on the

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[21] The Law of Ukraine "On Audit Activity" came into force on December 14, 2006.

[22] The Banking Law requires that the appointment of independent auditors be approved by the Supervisory Council, and the results of the audit be reviewed by the Auditing Commission.

[23] Article 17 of the Audit Law specifies that the auditor contracts with the customer (normally the entity, represented by the management or directors of the entity) to produce an audit report, in accordance with a contractual agreement. Examples of Ukrainian audit reports reviewed were generally addressed to the Board of Governors or the Board of Directors of the entities in question.

published audit report. Even though the threat is mitigated by the requirement to report to shareholders or their representatives any deficiencies identified during the audit, the auditor's report should be addressed to the shareholders of the entity, not the management.

32. **The Audit Law (2006) limits the contractual liability of the auditors to the damages actually incurred by the client as a result of their fault or negligence.** This limits the auditors' liability to losses incurred by the Board of Governors or Directors representing the entity. In addition, the Law does not include any requirement for auditors to have mandatory professional indemnity insurance.

33. **The Banking Law requires all banks operating in Ukraine to have an annual independent audit of their financial statements carried out by a licensed auditor who has a special 'B' certificate issued by the NBU authorizing the auditor to audit banks.** The NBU agreed on the content and format of this 'special certification' with the Chamber of Auditors, as well as on the Chamber administering this certification. The audits are required to be performed in accordance with ISA; however, the NBU requirement for the auditors' report covers different, and more, matters than are specified in the auditors' report per ISA.

34. **Existing legislation requires all NBFIs to undergo annual independent financial audit; the SCRFSM is charged with maintaining a registry of the auditors which are authorized to perform this work.** To be added to the registry, publicly available on the SCRFSM website, auditors need only to have a general audit license issued by the Chamber of Auditors, rather than have any specific certification.

35. **The requirement for auditors of banks and NBFIs to have further certification administered by the regulators appears to duplicate the role of the Chamber of Auditors.** The NBU and SCRFSM, together with the SSCMC, primarily regulate the entities they supervise; here they are regulating their auditors in addition. Where the NBU believes a bank's auditor to be incompetent it should in the first instance discuss its concerns with the bank and pass its concerns on to the Chamber of Auditors to take appropriate action regarding the auditor (which should include restricting the auditor's license if the Chamber has serious concerns about the auditor's ability to audit regulated entities). The Chamber should seek to provide auditors of regulated entities with sector-specific methodology and guidance where required. Over time, the regulators should thus be able to rely on the Chamber's supervision and not need to regulate auditors directly. The NBU should be a stakeholder of the CoAU and have representation at the CoAU as necessary.

B. The accounting and auditing professions

B.1. The accounting profession

36. **The number of professional accountants in Ukraine is not easy to accurately define; observers estimate that there may be as many as 500,000 accountants in Ukraine.[24]** Many of

[24] UFPAA website.

these work as 'chief accountants' in corporate entities, where they are often the only accounting staff and are responsible for internal and external financial reporting.

37. **There are three major professional organizations of accountants and auditors and one regulating/public oversight body for auditors in Ukraine.** The Ukrainian Union of Auditors (UUOA) is the largest professional association in terms of numbers (approximately 3,500 members); it was established by law (although the relevant provision was later deleted by an amendment) and its members elect the professional members of the CoAU. The older of the two accountancy organizations is the Ukrainian Federation of Professional Accountants and Auditors (UFPAA); it has circa 2,000 members,[25] Recently, it set new requirements for full membership, limiting it to persons who at a minimum have either passed qualification exams sponsored by UFPAA or have the CAP/CIPA qualification. The IASC Foundation has licensed UFPAA to coordinate the translation from English to Ukrainian following the official IASC Foundation process. Also, the IASC Foundation has concluded a copyright waiver agreement with the MoF for the official Ukrainian translation. In 2004, another professional organization, the Ukraine Association of Certified Accountants and Auditors (UACAA), was created. The UACAA currently has approximately 700 members, all of whom hold the CAP qualification. Section II.C of this report provides more detail on CAP/CIPA and other accounting qualifications, education and training in Ukraine. In addition, bookkeepers and accountants in the agricultural sector are organized in the Federation of Auditors and Accountants, and Financial Specialists of the Agriculture Complex of Ukraine.

38. **UFPAA is a full member of IFAC since November 2008; UACAA is applying for associate membership.** IFAC requires that its members, both associate and full, make their best efforts to comply with IFACs Statements of Membership Obligations (SMOs).[26] Both bodies are working to comply with the SMOs but they do not yet comply with all SMOs. Specifically, both bodies fall short of the SMOs in regard to SMO 1, *Quality Assurance* and SMO 6, *Investigation and Discipline* (see Section II.E below).

39. **After 16 years of independent development, the organized accounting profession, as represented by the two competing professional organizations, has only a relatively small membership which combined makes up less than 1% of the estimated total of Ukrainian accountants; this illustrates a major challenge facing the profession.** The inclusion of more accountants with the organized profession in Ukraine has been, and remains, hampered by disagreements within and between the bodies and, in particular, disagreements regarding what qualifications should be required as a prerequisite for membership of an organization. Setting high entrance qualification standards is essential to establish and maintain the reputation of the profession; however, such high standards may be acting as an impenetrable barrier to many accountants who were trained pre-1990 and are still very active in the profession.

40. **The development of the professional organizations has been influenced by the reliance on external funding from development agencies.** Such funding has played a

[25] UFPAA website.

[26] 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.

significant role in the establishment of the new accounting organization, UACAA, having previously funded the development of the existing organization, UFPAA. UFPAA has become financially self-sustainable; nevertheless both bodies would benefit from twinning opportunities with other European accounting bodies and continuing to work with development partners where appropriate. In addition, the government should seek to encourage the expansion of membership of these bodies as bringing more accountants within the organized profession will increase access to up-to-date training for preparers of financial statements.

41. **A small number of Ukrainians have taken internationally recognized English-language qualifications, primarily the ACCA exams administered by the British Council in Kiev.** It is estimated that there are approximately 200 accountants in Ukraine holding a foreign qualification, mostly ACCA-qualified. Approximately 950 students are currently studying for the English-language ACCA with international training providers in Ukraine. The majority of both holders of the qualifications and students are employed in the leading international network accountancy firms, banks and a handful of large companies.

42. **Outside the members of the professional organizations (many of whom hold the CAP qualification) and holders of foreign qualifications, accountants who prepare financial statements in Ukraine have in many cases received little or no training in modern, internationally recognized accounting techniques and financial reporting.** As a result, while Ukraine has adopted National Accounting Standards which 'do not contradict IFRS', many preparers struggle to understand and implement their requirements. Bookkeeping and financial reporting are often conducted according to the tax rules and concepts commonly used in the past. In particular, the principles-based accounting standards, which require interpretation and accounting estimates, are very different from the previous strictly regulated rules-based environment. The capacity of preparers of financial statements, and with it the quality of financial reporting, depends on improving the ability of all Ukrainian accountants to understand and apply the principles and concepts put forward in NAS and IFRS.[27]

43. **Educating accountants, such as 'chief accountants', who work at the majority of Ukrainian companies is key to improving the practical application of NAS, IFRS and principles-based accounting.**

B.2. The audit profession

44. **The Chamber of Auditors of Ukraine (CoAU) regulates auditors in Ukraine. The Chamber was established under the provisions of the Audit Law[28] as the regulatory body for the Ukrainian audit profession; it also has some features of an oversight body.** It is an independent legal entity, and is constituted of 20 permanent members (volunteers), including 10 representatives appointed by the state regulatory bodies including the Ministry of Finance, the State Tax Administration, the National Bank of Ukraine, the Ministry of Justice and the State

[27] It is important to note, that, in general, the situation is somewhat better in the financial sector, when compared to the other parts of economy.

[28] Provisions defining the CoAU status were first introduced in the 'old' Audit Law and were further reconfirmed and expanded in the new Audit Law (2006).

Statistics Committee and 10 representatives elected by the UUOA.[29] On a day-by-day basis the CoAU is run by the Head and a secretariat, financed out of its own funds. Currently the CoAU regulates approximately 3,300 registered auditors, employed in 1,200 firms. Its main responsibilities include:

- Performing professional certification of auditors;
- Setting audit standards and assisting in their implementation;
- Approving auditors' training curricula;
- Maintaining a registry of audit firms and individual auditors;
- Organizing quality control of audit services, as well as investigation and disciplinary procedures (by early 2008, 95 licenses were withdrawn – 87 formal reasons, 8 for breach of independence);
- Taking measures to ensure auditors' independence;
- Setting and enforcing CPD requirements, as well as setting requirements for trainers and training centres.

The CoAU has recently established a quality assurance committee, envisaged to function as an semi-autonomous body reporting to the CoAU. Given the recent amendments to the EU's Eighth Company Law Directive on audit, the position, mandate and responsibilities of the Chamber should be clarified in legislation, particularly in relation to its function as a public oversight body. The CoAU already undertakes many functions of a public oversight body and with certain adjustments to the membership and mandate given by the law, it can successfully become a full-fledged public oversight body. The CoAU will need support in the implementation of the public oversight mandate.

45. **The current requirements to obtain professional audit certification comprise a two-stage examination process, three years of practical experience, and relevant degree-level education (economics or law).** Holders of internationally recognized qualifications such as ACCA are granted an exemption from the first stage examination, which tests basic accounting and auditing skills. The second stage examination addresses practical skills of auditing and is in more of a case study format. Successful candidates are awarded the professional qualification and are eligible to be registered in the Registry maintained by the CoAU. The CoAU conducts a specialized training course to prepare candidates for the examination. While there is a significant demand for this course, the lack of adequately qualified instructors is a problem. Under the existing market conditions, with the demand for accounting professionals far exceeding supply, it is difficult for the CoAU to attract and retain qualified personnel.

46. **The CoAU adopted ISAs as the national standards for auditors in 2003 and produces annually the official translation of ISA; however, many local audit firms are struggling to implement these standards in practice.** The CoAU addresses this by publishing an audit methodology, including sample work schedules, and through publishing a professional magazine; however, it itself suffers from the same lack of capacity as the rest of the profession. Particular problems arise with regard to the audit of the new sectors of economy, such as insurance, non-state pension funds and other non-banking financial services.

[29] The Chair of the CoAU is elected from among its twenty members. Only the Chair is remunerated; all others perform their duties on an unremunerated basis.

47. **There was consistent anecdotal evidence of a problem with the perceived quality and value of audit; this was attributed to the fact that the current requirement and demand for statutory audit, based on legislative and market requirements, significantly exceed the capacity of the audit profession to deliver high-quality audits.** As a result, there is a widespread perception that only a very few local audit firms are capable of performing ISA-compliant audits and that, outside these few firms, audit quality is very low, even to the extent that no effective assurance is given. The very low price paid for many audits adds to this perception. Large differences in the technical proficiency, level of experience and level of resources across audit firms contribute to the significant variations in audit quality. While the local member firms of international audit firm networks have the benefit of firm-wide internal quality control procedures, many local firms have to solely rely on their own, limited resources and experience. In addition, there is little or no effective quality control of auditors by the CoAU; their system of monitoring the quality of auditors is based on peer review, has only been started in the last year, and has covered less than 20 auditors to date. Quality control of auditors is covered in more detail in Section E.2 below.

48. **The CoAU's ethical requirements follow international standards, but are not effectively enforced.** The CoAU translated the November 2001 version of the IFAC Code of Ethics and compliance with it was made mandatory for all auditors. The translated ethics code has 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. However, ethical requirements are not effectively enforced by the CoAU.

C. Professional Education and Training

49. **Professional accounting education and training in accountancy and auditing in Ukraine is needed by all participants in the corporate financial reporting process.** Education and training in accountancy is delivered at two stages – at the higher education level and at professional level once accountants have begun working.

50. **Accountancy and audit education is offered at universities, colleges and business schools in Ukraine, both as part of economics or business administration degrees and as specific accounting degrees.** Universities do not have any difficulties recruiting students for business and economics degrees, and many such students take accountancy options. Such courses' curricula generally include teaching NAS and in some but not all cases also cover IFRS. However, some of the courses are not up-to-date and do not cover all accounting concepts, principles and standards which underlie NAS, which are based on IFRS. Cooperation between the professional organizations and university level education providers appears limited, even though UFPAA has begun working with universities on modernizing the curricula. Further improvement in the area of professional education may be available by means of establishing an integrated professional education system in compliance with the IES and the Eighth EU Company Law Directive.

51. **The range of professional accounting education and training available currently in Ukraine includes:**

- Audit certification program operated by UUOA and CoAU since 2003, based on ISA andf IFAC Code of Ethics. Average pass rate among candidates fluctuates between 35 and 50 %. CoAU has also established a network of training centres, used for both pre-qualification and CPD education.
- Courses for accountants and auditors coordinated by the professional organizations, UFPAA and UACAA. These are offered both to members to facilitate their continuous professional development and to non-members. Such courses include basic accountancy training (including the CAP qualification that is now the entrance criterion for both professional organizations) and IFRS conversion training courses. These courses are offered across Ukraine through regional and district branch offices.
- Study towards the CAP/CIPA program, offered by various private trainers across Ukraine. CAP/CIPA is a seven paper qualification program which is taught and examined in the Russian language. The first three papers in financial accounting, management accounting and local tax and law, comprise the Certified Accounting Practitioner (CAP) qualification; students who go on to complete the four further papers gain the Certified International Professional Accountant (CIPA) qualification. As at July 2007 there were 2,078 qualified CAPs in Ukraine and 50 CIPAs; a further 700 are studying towards CAP. CAP typically takes 6-12 months to complete, CIPA 2-3 years. CAP is the minimum entrance requirement for membership of both UFPAA and UACAA, though some current members of UFPAA may not hold the qualification.
- Study towards the ACCA's Diploma in IFRS, Dip IFRA (Russ). This is the only ACCA qualification which currently taught and examined in Russian. The course was originally intended to be an IFRS conversion or update course for holders of the full ACCA qualification but is taken in Ukraine and other Russian-speaking countries by many who have no other formal accountancy qualification. It typically takes 3 months of study and leads to a single examination.
- Study towards the English-language ACCA qualification with private training providers. Examinations are administered by the British Council in Kiev. It is estimated that up to 180 Ukrainians have qualified through this route and a further 750 are currently studying.[30] The qualification typically takes 3-5 years to complete and is relatively expensive.

52. **The capacity of the current provision of education and training in accountancy detailed above should be evaluated in light of the IFRS adoption.** Syllabi for university education do not always cover NAS and modern accounting techniques and principles. With regard to post-graduate professional education and training, there needs to be more 'local' adoption and recognition of training that meets the required standard, which should be the appropriate international education standard. At present, professional courses available in Ukrainian are scarce and have little or no market recognition. The CAP/CIPA qualification, available in Russian, has been relatively successful (delivering over 2,000 accountants trained to the basic CAP level) but it lacks sufficient official or professional market recognition to scale up further quickly. The conversion course to IFRS (available in Russian) is limited in scope and is not applicable to entities which apply NAS; English language qualifications are inaccessible to many due to cost and language constraints. Measures are needed to stimulate and improve the provision of local language (ideally Ukrainian, but lacking that, Russian) accounting education and training in Ukraine.

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[30] It may be possible to self-study towards other international accountancy qualifications such as the United States Certified Public Accountant qualification. However, such cases are limited to a very few professionals employed by the 'Big 4'.

53. **Professional organizations should be encouraged to work more closely with universities and business schools (or the relevant department of the Ministry of Education and Science) to enhance the quality of the accounting training provided; where possible syllabi should be coordinated so that exemptions from basic accountancy qualifications such as CAP or early ACCA papers are available to students who have majored in accountancy.** The availability of such exemptions reduces the length of time required to complete subsequent professional qualifications, and thus increases training capacity. In addition, there is a major need to enhance the resources available to university faculties teaching accounting, both in terms of updating the skills and knowledge of faculty staff and in the provision of textbooks, training materials and reference materials such as local-language copies of IFRS, ISAs and NAS etc.

54. **Participants in the financial reporting process need to be encouraged to gain the education and training they need to meet requirements made of them in their role.** The Ukraine government, regulators, professional bodies and education providers should work together to decide on appropriate target educational standards and qualifications suitable for rapidly expanding Ukraine's accounting capacity. In this regard, the CAP qualification may be an example of a useful starting point as it is already available across Ukraine. However, in the longer term a Ukrainian language qualification should be made available.

55. **Continuing Professional Development (CPD) is required for auditors and accountants by all three professional organizations; IFAC-member professional bodies are required to promote and facilitate CPD as part of their membership obligations.**

56. **From discussions with representatives of commercial banks and leading industrial companies, it was clear that the current training offered on IFRS and changes in IFRS is not sufficient, especially for banking and financial sector employees; therefore, a lot of IFRS knowledge is obtained through self-study or from the international audit firms (mostly the 'Big 4').** This issue is especially relevant for local companies since foreign owned entities can access training programs offered by their parent companies. The representatives of the banks and companies also recognized that the number of adequately educated (IFRS educated) accountants in the market is not sufficient, and that even large companies have difficulties in attracting appropriate personnel capable of ensuring accurate preparation of IFRS-compliant financial statements. As a consequence, where IFRS financial statements are prepared, to a large extent the preparation is done by the audit firm (usually Big 4) and the company itself might have limited understanding on their content. This preparation of financial statements by the audit firms may be in breach of ethical/independence rules.

D. Setting Accounting and Auditing Standards

57. **The accounting standards-setting process in Ukraine involves the development and adoption of Ukrainian National Accounting Standards (NAS).** The NAS are developed, adopted and published by the Ministry of Finance in consultation with its Accounting Methodology Committee (AMC)[31]. According to the Law on Accounting, these NAS 'should not

[31] The AMC has representatives from professional auditing and accounting bodies as well as other government ministries, academia and industry bodies. The process of adopting accounting standards includes public consultation.

contradict IFRS'. However, differences remain between NAS and IFRS; these are analyzed in Section III below. Section III also highlights significant problems with the application of both NAS and IFRS. At present the MoF, as well as various professional organizations, develops and publishes methodological guidance in Ukrainian for NAS.

58. **Accounting standards for banks are based on regulations and instructions issued by the National Bank of Ukraine.** These regulations and instructions are primarily based on IFRS, however, they do not cover all aspects of IFRS and, in some instances, actually disapply certain requirements of IFRS (see paragraph 84) However, IAS 1 clearly states that compliance with IFRS cannot be partial – either all IFRS is complied with, or no compliance can be claimed. Thus banks cannot be said to be required to apply IFRS at present.

59. **There are no specific regulations governing accounting and auditing standards for specific activities by insurance companies or pension funds; they apply NAS as per the requirement for other companies.** The Law on Insurance does set out some basic principles in relation to accounting for insurance reserves, though these requirements comply with the NAS on accounting for estimates. The Law also provides a method for calculating unearned premium reserves which, however, does not follow best international practice for such reserving.

60. **The Chamber of Auditors of Ukraine (CoAU) is responsible for the translation of ISA, which all auditors are required to apply.** The 2005 version of the IFAC Handbook of International Auditing, Assurance, and Ethics Pronouncements, which includes ISA, the International Auditing Practice Statements (IAPS), the Code of Ethics for Professional Accountants, etc. has recently been translated. ISA and ISQC1 (a standard complementary to ISA on audit firm's internal quality controls), translated into Ukrainian, are made available for purchase to professionals in the Ukraine in the form of a handbook of auditing standards. An analysis of the practice of auditing standards is given in Section IV below.

61. **The application of IFRS is not currently required for any entities in Ukraine, though some larger entities voluntarily apply it, and banks apply banking regulations which are close to requiring IFRS.** IFRS is set by the IASB, outside of Ukraine. UFPAA, under the agreement with the IASC Foundation, is undertaking the translation of IFRS periodically. At the date of this report, an official Ukrainian translation of the 2005 bound version of IFRS is available. The process of translating IFRS and ISA has been undertaken with donor support in the past but is now self-funded, which is a commendable achievement by the UFPAA. The translation of IFRS and ISA is not an ongoing and sustained effort; translations have been updated every few years. The current process does not allow for ongoing translation of IFRS and ISA into the Ukrainian language as they are being amended and most individual accountants, auditors and audit firms are not in a position to apply the latest changes as they are published by the IASB (for IFRS) and the IAASB, part of IFAC, (for ISA). However, the problems with regard to the practice of IFRS and ISA (see Sections III and IV) are at a much more basic level than the problems that may result from a time-lag in periodic translation of standards; so issues with the translation of IFRS and ISA are not the most important in improving the quality of financial reporting in Ukraine.

E. Enforcing Accounting and Auditing Standards

E.1 Enforcing Accounting (Financial Reporting) Standards

62. **A proper and rigorous enforcement regime for financial reporting is key to establishing and maintaining the quality of financial reporting and to underpinning investors' confidence in financial markets.**[32] Enforcing the proper application of the financial reporting standards in Ukraine is the responsibility of regulators, primarily the SSCMC (for companies with securities), the NBU (for banks) and the SCRFSM (for NBFIs). Combined, they are currently responsible for the monitoring and oversight of approximately 35,000 companies, including all open and closed joint stock companies. The 2002 ROSC assessment noted that, while the regulators generally had sufficient authority to monitor compliance with legal and financial reporting requirements, they lacked the influence, resources and expertise to carry out their functions effectively.

63. **Certain progress has been achieved since then. However, significant challenges remain which must be overcome if the regulators are to become effective enforcers of the high-quality financial information.** Some of the most notable concerns include the following:

- All three regulators face the problem of finite, limited resources and the need to use those limited resources effectively and efficiently. In case of the SSCMC, the situation is worsened by the excessively broad mandate. Under the existing arrangements it has around 35,000 public joint-stock companies under its authority, all of which are required to periodically submit their financial statements. The SSCMC is required to process, analyse and monitor all of these financial statements. Testing all of the financial statements of regulated entities each year does not use available resources effectively and results in an inadequate quality of the conducted reviews, making effective supervision nearly impossible. All three regulators must direct work to those areas where the risk is greatest. Risk (in a regulatory sense) is the combination of impact and probability, where impact is the effect that a misstatement of those financial statements would have on the confidence in the accounting and financial system and probability is the risk that those financial statements are misstated. The establishment of an effective risk assessment system and a gradual transition to risk-based supervision are essential if the regulators are to effectively monitor compliance with the applicable reporting framework.
- The oversight work of the SSCMC is focused on enforcing timeliness of filings, and revealing incomplete statements and inconsistencies between narrative and numerical information. There is little or no monitoring of compliance of the statements with the relevant accounting framework. The extension of the SSCMC's role to cover monitoring compliance with the applicable reporting framework and taking appropriate measures in the case of infringements discovered in the course of the review[33] is essential if the Securities Commission is to operate in a manner similar to accounting enforcers in the EU. This will only be possible if a reduced mandate in respect of number of companies is adopted.
- The regulators must have adequate enforcement capability. For example, the current maximum penalty available to the SSCMC for non-submission, late submission or submission of knowingly false financial information is approximately 17,000 Hrivnas,

[32] Recital 16 of EC directive 1606/2002, otherwise known as the IAS Regulations

[33] As per the definition of enforcement in Committee of European Securities Regulators Standard No 1 on Financial Information: Enforcement of Standards on Financial Information in Europe.

roughly USD$3,400, which appears insufficient, particularly for larger companies[34]; in addition, sanctions involve extensive bureaucratic procedures to be enforced. In the absence of a well-developed internal stock market, which could act as a 'natural' enforcement tool, entities are often inclined to either ignore or delay the implementation of the SSCMC comments and recommendations.

- There is a need for continuing capacity strengthening in the enforcement departments of each regulator. In particular, if application of IFRS were to become compulsory in financial reporting of regulated entities, additional training would be needed for the supervision staff as few have IFRS expertise at present. Also the number of supervision staff should be sufficient to enable proper enforcement.

E.2 Enforcing Auditing Standards

64. **Enforcing auditing standards contributes to ensuring audit quality which in turn can add credibility to published financial information and act as an important protection mechanism for shareholders, creditors and other stakeholders.** The Chamber of Auditors of Ukraine (CoAU) is responsible for monitoring and enforcing compliance with auditing standards by the statutory auditors it supervises.

65. **The new Audit Law confirms the CoAU's responsibility for the quality control of auditors, requires the audit firms and individual auditors to submit annual returns to the CoAU and provides the CoAU with a range of disciplinary measures which can be applied in cases of infringements.** The maximum disciplinary measure provided by the Audit Law allows the CoAU to cancel an auditor's license and to remove the audit firm or auditor from the official register. As a result, the CoAU has the authority to monitor and enforce audit quality.

66. **The CoAU has recently introduced a program of quality control reviews of the auditors it supervises.** This program is based on peer-reviews of one audit firm by another, performed by auditors registered with the CoAU on a 'pro bono' basis. To become peer-reviewers, auditors have to apply to the CoAU and be elected by the general meeting of the regional branch of the Association of Auditors of Ukraine. The program is very much in its infancy; less than 20 reviews have been completed at the time of this report. The effectiveness of these reviews is widely perceived as poor, undermined by the low capacity and insufficient commitment on part of the reviewers, who have to perform these duties on top of their normal work, and by distrust on the part of the audit firms under review, who cite concerns about the unfair competition impact of the reviews and breach of confidence.

67. **The CoAU must continue to develop and improve its quality control function. If it retains the peer review system it could seek to learn from other European audit regulators who operate such a system, such as in France and Germany. An alternative is to adopt a mechanism where the CoAU has a permanent independent team of audit inspectors who visit auditors and audit firms and perform on-site quality reviews.** Such systems are operated in other European countries such as the UK and Lithuania. Under either system, a key priority is

[34] As an example, in the UK the late filing/submission of financial statements could be penalized by up to GBP 7,500 in case of public companies and a delay of over 6 months, and in case of non-filing for over 2 years, the company is wound up. Moreover, directors of companies found to have materially misstated the information in financial statements may be required to personally cover the costs of reissuing, republishing and resending financial statements to all relevant authorities and shareholders.

for the CoAU to expand its program so that all registered auditors are inspected within a target period; the EU's Eighth Company Law Directive sets out that all registered auditors must be subject to monitoring within a six-year cycle, and that auditors of public interest companies be monitored every 3 years. Even assuming a ten year timeframe, the CoAU must visit 120 firms per year, which is significantly beyond its current capacity.

68. **The format, work program and scope of the inspection visits should be standardized so that the committee at the CoAU which receives and reviews the reports from the inspection visits can rely on the consistency of the visit outcomes.** The outcomes of inspection visits must lead to appropriate action. Where significant deficiencies are found, licenses should be removed or suspended conditional on improvements and re-training. Where less significant deficiencies are found, the CoAU should develop a range of measures such as requiring targeted training, the adoption and application by the auditor of a standard audit methodology and other remedial action. Where such improvements are not confirmed by a subsequent inspection, the auditor's license should be removed. The removal from the register of auditors who are not able to perform audits to the required standard, and the improvement in the standard of work of those that remain will over time improve the quality, and the perceived quality, of statutory audit in Ukraine.

III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

69. **The purpose of this section is to analyze the differences between Ukrainian National Accounting Standards (NAS) and IFRS (the 'standards gap') and the compliance of the statutory financial statements with NAS (the 'compliance gap') to identify any systemic non-compliance issues; the potential adverse impact on the reliability of NAS-compliant financial statements of both gaps is also analyzed.**

70. **All companies are currently required to use NAS in the preparation of their financial statements.** However, some larger companies choose additionally to prepare IFRS accounts, separately from the NAS accounts. An analysis of the compliance with IFRS of a sample of such financial statements prepared in accordance with IFRS is also given below.

F. The Accounting Standards Gap

71. **There are material differences between National Accounting Standards and IFRS. National Accounting Standards are prepared and adopted by the MoF and are required by the Law on Accounting to not be in conflict with IFRS.** A comparative analysis indicated that there are some differences between the two sets of standards. These may be summarized as follows:

- NAS, although developed on the basis of IFRS, do not entirely reflect the latest developments in IFRS; for example, some recent standards are not covered under NAS (IFRS 7 Financial Instruments: Disclosures, IFRS 4 Insurance Contracts), as well as other older standards (IAS 37 Provisions, Contingent Liabilities and Contingent Assets, IAS 34 Interim Financial Reporting);

- NAS are less demanding in disclosures; for example IFRS requires the disclosure of compensation paid by the entity to key personnel, however this is not required under NAS.

The impact of the above differences on the usefulness of financial statements prepared according to NAS as compared to IFRS may in some cases be material (the differences may be even more significant if the NAS disclosure requirements are not followed – see also paragraph 75 on the compliance gap). The existence of the differences may result in a lack of comparability to IFRS financial statements and restricts the usefulness of NAS financial statements to users not knowledgeable about Ukrainian NAS.

72. **Another source of a 'standards gap' is where regulators, such as for example the NBU, set accounting regulations for the entities which they regulate which differ or contradict the requirements of accounting standards.** It is common for regulators to require information, including financial information, from their regulated entities further to that required in the general purpose statutory accounts. This regulatory reporting can be a different basis than that required under the applicable accounting standards, and regulated entities must reconcile one with the other. This is evident in the banking sector in Ukraine; banks prepare NAS-compliant financial statements for statutory purposes and separate financial statements compliant with the NBU's accounting regulations (based on IFRS) as required by the NBU's regulations.

73. **Selected key differences between the NBU's accounting (as distinct from prudential) regulations and IFRS that may have a significant impact on the comparability to IFRS of the financial statements of banks prepared per the NBU's regulations include the following:**

- Certain key areas of IFRS, such as the requirement to state the ultimate beneficial owner and certain requirements of IAS 24, *Related Party Transactions*, and accounting regulations for derivative accounting are not covered by accounting regulations and instructions of NBU.
- The accounting regulations of the NBU with respect to interest expense and revenue recognition requirements do not reflect the effective yield, which is likely to overstate income in the banking sector compared to the IFRS treatment.
- Allowances 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 NBU has determined that consolidated financial statements must be submitted, however, there is a lack of regulations regarding the scope of consolidation therefore material investments in subsidiaries, associates or mutual funds might remain unconsolidated.
- The NBU accounting regulations do not cover creation of accruals for unused vacation pay and provisions as per IAS 37.

74. **The result of such differences is that banks may find it difficult to comply with IFRS and the NBU's regulations at the same time, and thus their financial statements may not comply with IFRS.** Any requirement for entities such as banks, other financial institutions and listed companies to adopt IFRS, as recently proposed in Ukraine, must be accompanied by a review of the relevant regulations applying to such entities for compatibility with IFRS.

G. The Compliance Gap

75. **The ROSC assessed the compliance gap, sampling**:

- 15 sets of audited financial statements, which purport to be prepared in accordance with NAS. For the sample review, the ROSC team selected 14 industrial companies and one bank. All sets of financial statements in the sample were audited by local audit firms with no international affiliation. Thirteen audit reports were unqualified and two were qualified.
- 11 sets of audited financial statements, which purport to be prepared in accordance with IFRS. For the sample review, the ROSC team reviewed six banks, four industrial companies and one not-for-profit entity. All financial statements in the sample were audited by local member firms of international audit firm networks. Six audit reports were unqualified (one included an emphasis of a matter paragraph) and five were qualified (one of which also had an emphasis of matter paragraph).

H. NAS Compliance

76. **Companies are required to submit annual financial information to the State Statistics Committee (they are now not required to submit their statements with the tax returns as they were until recently).** Apart from the limited review of financial statements by regulators described above in Section IIE, limited to joint stock companies and regulated entities, there appears to be little use made of the financial statements external to the company, its management and owners. For example, limited use of financial statements is made by banks as a basis for loan decisions; collateral-backed lending is prevalent. However, there is evidence of increasing demand for, and usage of, financial statements in lending decisions. Areas of noted non-compliance include:

- Non-disclosure of related party transactions;
- Non-disclosure of the accounting policies adopted;
- Non-provision of liabilities for which the measurement is not supported by third party evidence; such provisions are generally not allowable for taxation purposes and would include categories such as holiday pay provision and doubtful debt provision ;
- Non-provision of deferred taxation;
- Non-disclosure of earnings per share;
- Assets carried at historical cost where there is evidence of impairment; and
- Failure to include a cash flow statement.

77. **The differences in the bases of key accounting items in general purpose financial statements prepared according to NAS and accounting items calculated as part of the calculation of corporate taxation is probably the major factor in non-compliance with NAS.** Where the rules and standards for taxation purposes are different to those in NAS, many preparers will use the taxation rules. This leads to differences relating to accounting estimates (as taxation calculations do not generally allow estimates), valuation of assets and liabilities (taxation often

requires a formulaic approach and the recognition of liabilities only if supported by paper-based evidence), and inaccurate use of accruals.

I. IFRS compliance

78. **As noted above, IFRS financial statements are not prepared to satisfy a statutory requirement; instead they are prepared to satisfy the needs of investors and other stakeholders.** They are generally prepared with the assistance of an international accountancy firm and are often audited by the same firm (leading to potential conflicts of interest); the company's NAS accounts are usually prepared by the company alone and audited by a different, often local, audit firm. Areas of noted non-compliance in the IFRS financial statements include:

- Failure to disclose related party transactions and the ultimate controlling party;
- Some consolidated statements did not consolidate all controlled subsidiaries and special purpose entities;
- Weak compliance with the requirement for reporting by business segment;
- Disclosures in respect of revalued property, plant and equipment were generally weak, even though there was evidence of substantial revaluations;
- Disclosures in respect of intangible assets were weak, particularly in relation to impairment reviews;
- Disclosure of significant judgments and estimates appeared to be of a high quality[35] in the banks, but was of lower quality in the industrials;
- In a number of instances fair value estimates for financial instruments carried at amortized cost were not provided, and explanations why the fair values approximate amortized cost were weak; and
- Disclosures related to the acquisitions and sales of subsidiaries were not always provided.

79. **Many of the deficiencies noted above, in particular incomplete consolidations and the absence of appropriate or complete disclosures relating to related parties and ultimate beneficial owners, make it difficult for users to make a proper assessment of the financial position and performance of an entity.** The level of compliance with IFRS in the sample's six banks which have voluntarily produced IFRS financial statements was better than in non-banks but there were still some significant weaknesses. In meetings with a variety of companies and banks, it was difficult to assess directly the causes of problems in preparing IFRS financial statements, as the chief accountants were usually not involved in the preparation of financial statements under IFRS. Instead, such statements were often prepared (and audited) by the audit firms, which raises ethical and independence issues for the auditors involved.

80. **Preparers of financial statements at insurance companies indicated that they experience particular difficulties due to a lack of adequate guidance and support in areas specific to insurance.** Calculating appropriate reserves ('reserving') presents one of the biggest challenges to insurance companies in Ukraine. The nature of insurance business written (mainly property damage) and the fixed rules applied to certain liability business means that the claims

[35] This is in contrast to many EU companies, where compliance with these requirements has been highlighted as an area of weakness.

currently have a short timeframe compared to international norms; this simplifies the process of reserving. However, as the industry develops, processes and policies will become more complex and life-insurance will expand, thereby lengthening the timeframe of claims and making reserving more difficult. Adherence to standards in accounting for estimates is therefore likely to become an even greater challenge. Also, the IASB has an ongoing project on IFRS for insurance transactions, and the authorities should monitor its developments.

IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

The auditing standards gap

81. **The CoAU adopted International Standards on Auditing (ISA) as promulgated by the IAASB for all Ukrainian auditors and audit firms in 2003.** The CoAU adopts ISA as they are released by the IAASB, so there is no standards gap with ISA. Further work will be needed after the IAASB completes the clarity project and a new version of ISAs is issued.

The auditing standards compliance gap

82. **The audit reports in the sample of 15 NAS and 11 IFRS financial statements were reviewed and interviews were held with auditors from a variety of small and large audit firms in Ukraine.** The audit reports for the NAS financial statements were not generally compliant with the format and wording required under ISAs for an audit opinion; common differences included reports addressing the company management, reports covering a wider scope of issues than the auditor's opinion on the financial statements, and inaccurate wording.

83. **The auditors' reports on the financial statements prepared in accordance with IFRS appeared to be compliant with ISA.** However, from discussions with the accounting personnel of some of the entities reviewed it appeared that the IFRS financial statements are largely prepared by the auditors themselves. Preparing and then auditing financial statements is not compliant with ISA, and raises issues of independence which may conflict with the ethical code for auditors.

84. **From the discussions with auditors from a variety of audit firms in Ukraine it is clear that the level of compliance with ISA was determined by the audit methodology used by audit firms.** Application of the ISA standards requires an auditor to make an assessment of risk and internal controls, leading to an audit strategy and plan that encompass systems, transactions and balance testing which will enable the auditor to gain sufficient and appropriate audit evidence to enable him to express an opinion on the financial statements. The CoAU has published a Manual of Auditing, which details a suggested audit methodology to comply with ISAs; however, its use is not compulsory for audit firms and the manual needs to be updated to reflect the changes added to the 2005 version of ISAs. In addition, the methodology in the Manual of Auditing is generic; it does not address tailoring of an audit for specialized sectors of economy, such as auditing banks and NBFIs, for which very little guidance and expertise is available.

85. **Use of the CoAU's Manual need not be made compulsory for all auditors or audit firms – some firms such as international network firms have well developed audit**

methodologies of their own. However, many smaller firms or individual auditors do not have a well-developed ISA compliant audit methodology. Where an audit quality inspection finds deficiencies in an auditor's practices, use of the Manual or aspects of it could be a condition of continued registration. Requiring targeted training (or re-training) on the use of a suitable audit methodology is another option for the CoAU to impose as a condition to remedy weaknesses noted in inspections.

86. **The process of reviewing and updating the methodology in the CoAU's Audit Manual materials on a periodic or continuous basis requires significant technical resources which are currently insuficient.** However, increasing market demand for high quality independent ISA audits and the introduction of effective quality control of auditors should stimulate a demand for a high-quality audit manual, and some of the costs of developing and maintaining the manual may be recouped through its sales. A software-based manual is more amenable to update and revision than the re-issuance of hard copy manuals, but developing such a manual would involve even more of the CoAU's scarce resource.

87. **The existence of insurance companies allegedly created for taxation purposes (see paragraph 6 above) would indicate that auditors of such companies are not complying with ISA, for example in relation to ISA 550, Related Parties.** Auditors could also identify such problems through the application of ISA 315, Understanding the Entity and its Environment. This is an illustrative example of the difficulties faced by Ukrainian auditors in applying ISA tailored to specialized industries. The CoAU is currently considering how to provide technical advice and training on the application of ISAs to specialized audit engagements (e.g. banks, credit unions, pensions, insurance etc.). The guidance and training should detail relevant Ukrainian law and regulations and should be developed in close co-operation with the relevant regulators.

V. PERCEPTION OF THE QUALITY OF FINANCIAL REPORTING

88. **Based on the materials available to the ROSC team, expert opinions and discussions with users of financial information, the conclusion could be made that there is a general perception that statutory financial statements prepared in Ukraine are of low quality.** There is a perception that the financial statements purporting to comply with IFRS prepared by banks (as required by NBU regulations) and voluntarily by certain other large companies are more reliable and of higher quality, though even banks struggle to apply certain standards, such as IAS 39, accurately. The market attributes the higher perceived quality of the non-statutory financial statements to the closer monitoring and enforcement from the National Bank of Ukraine, the banks' and larger companies' ability to attract professionals with a better understanding of IFRS, and the fact that virtually all main banks and large companies are audited by local member firms of international audit firm networks. On the other hand, the market attributes the poor perceived quality of statutory financial statements to the limited demand for financial information from third parties, strong influence 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 Ukrainian NAS.

89. **In general, commercial banks do not rely on the financial statements presented by potential borrowers in determining whether to extend credit.** There is a perception among the

banks that, with exception of financial statements purporting to comply with IFRS audited by international audit firms, the financial statements of companies in Ukraine are of a low quality and do not represent sufficient basis for assessing the financial position of a potential borrower. Although entities are often required to submit their financial statements as part of the loan application process, banks base their lending decisions on other factors including the amount of collateral, business forecasts and site visits. The financial statements of companies prepared in accordance with Ukrainian NAS and the related auditors' opinions are seen by banks as indications of merely their tax and legal compliance.

90. **Auditors' reports issued by the local audit firms have limited perceived value because there is an overwhelming perception that such audit reports are prepared by 'underqualified' auditors, without proper compliance with appropriate auditing standards.** This view was held by various regulators, commercial banks, educators, accountants, and even some auditors themselves. As discussed in Section II.E, the ineffectiveness of the existing quality control and enforcement mechanism contributes to the problem. Overall, there is a general issue of an audit being perceived by the public as an unavoidable, but rarely useful, burden rather than as an independent assurance of the quality of financial information.

VI. ACCOUNTING AND AUDITING IMPLICATIONS OF RECENT DEVELOPMENTS IN THE FINANCIAL-INDUSTRIAL GROUPS AND BANKING SECTOR

91. **The banking sector and the group of large conglomerates referred to as the financial-industrial groups (FIGs) are two of the most important sectors of the Ukraine economy.** The effects of recent developments in both sectors has implications for the wider economy in Ukraine; this is also true for accounting and auditing in Ukraine, as both sectors are seen as leaders in accounting and auditing.

92. **In the 1990s, a group of large financial-industrial groups (FIGs), representing conglomerates of industrial entities and commercial banks, emerged.** Since then, the FIGs have played a significant role in both the development of corporate sector and the economic performance of the country and now account for a substantial portion of Ukraine's GDP. Many of the FIGs were created through less than perfectly transparent privatization of state assets; recently, however, there are signs that some of the FIGs are making efforts to improve corporate transparency. The indications are that, once a FIG's internal ownership structure becomes clearly established, emerging growth and development needs push it towards a more compliant approach to corporate governance and greater transparency, including improved accounting and financial reporting.

93. **One driver of the efforts to improve financial reporting is that some of the FIGs, corporations and banks have tried to access international financial markets in an effort to raise investment and working capital, or to raise funds generally.** At present, successful fundraisings remain relatively isolated; preferred instruments of choice appear to be loan participation notes and depositary receipts, issued with the assistance of major international investment banks. Changing corporate management patterns (including the separation of

ownership and control) and the efforts to access international financial markets are creating a demand for reliable, accurate and timely financial information, prepared in compliance with international standards and examined by independent auditors. Some of the FIGs were among the first to recognize this need for high quality financial information; as early as 2005 one of the major FIGs prepared for the first time consolidated, IFRS-based financial statements and received an unqualified audit opinion from one of the local member firms of leading international audit networks. The group is currently putting in place procedures which would allow them to produce consolidated, IFRS-based financial statements on a regular basis, and to make them relevant to the day-to-day management activities. This is an entirely voluntarily effort, performed at the initiative of the owner and management.

94. **The voluntary production of IFRS-compliant financial statements by some FIGs and other large companies is an indicator of the increasing market demand for reliable financial information complaint with international standards.** This demand is likely to increase as Ukraine's economy continues to grow and more companies seek access to foreign capital; the emergence of non-state pension funds seeking to invest internally in Ukrainian equity will also add to the demand. It is because of this demand that the proposed amendment to require certain companies (listed companies, banks, NBFIs etc) to apply IFRS is timely, demand-driven and will actually eliminate duplicative work.

95. **A review of the financial statements of recently-acquired local banks indicated a common trend whereby before the transaction takes place, an internal restructuring is performed to eliminate non-banking assets, including shares in non-banking subsidiaries.** Part of the due diligence performed by the potential buyer would include a detailed review of the available financial information. Where the local bank had prepared financial statements purporting to comply with IFRS the reliance on the financial information would significantly increase, particularly if the statements were audited by local member firms of an international audit firm. Conversely, investors have been wary of buying banks perceived to have a low level of transparency and reliable financial information as bidders were unable to get a clear picture of the target bank's market position and potential problems.

96. **This recent activity in the banking sector has increased demand for high-quality IFRS compliant financial information.** After foreign banks enter the Ukraine market they aim to produce quality periodical financial information at the level required by their international headquarters. This in turn increases pressure on local banks to follow similar standards if they are to withstand increasing competition or find potential investors. In addition, as lending to private sector entities increases, it is reasonable to expect that bankers will increasingly rely on financial information in their decision-making process, rewarding quality with better lending terms. Thus, momentum for improved quality financial information is likely to go beyond the banking area and have a cross-sectoral impact. This will also increase demand for high quality independent audit; the reforms and recommendations proposed in this report for developing the quality of the accounting and auditing professions in Ukraine do not stand alone simply to benefit the professions; they are genuinely demand driven by recent developments in the Ukraine corporate sector. The demand for improvements in quality of financial reporting and auditing has been led by the banking and FIG sector, but is already extending to other large and medium-sized entities in Ukraine.

VII. POLICY RECOMMENDATIONS

97. **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.** Strengthening the financial reporting infrastructure contributes to the following development objectives: (i) Enhancing the business climate and stimulating investments; (ii) Strengthening the stability and competitiveness of the banking and non-banking financial sectors; and mitigating the risk of crises due to loan collection problems and weak capital base; (iii) Encouraging greater transparency in both State and privately-owned enterprises, thus allowing shareholders and the public at large to assess management performance and influence its behavior; (iv) Aligning the normative and legal framework in the area of financial reporting, accounting and auditing with the EU legislation and the best international practices; (v) Facilitating SME access to credit by encouraging a shift from collateral-based lending decisions to lending decisions based on the financial performance of the prospective borrower, thereby supporting growth in the SME sector; and (vi) Helping to ensure that the financial reporting and auditing rules applicable to different types and sizes of entity are appropriate to the needs of those entities and the users of their financial statements. Without attempting to provide a detailed tactical design for reforms, this report sketches the policy recommendations to support the implementation of accounting reform and ultimately enhance the quality of corporate financial reporting.

98. **The recommendations of this ROSC are interrelated and mutually supportive, designed to collectively improve the financial reporting environment in Ukraine.** For example, good accounting standards are jeopardized if practitioners do not understand how to translate them into journal entries; a rigorous statutory and regulatory framework is unlikely to be effective if it is not enforced. Additionally, some recommendations will not have an immediate effect but still remain of high priority if the financial reporting environment in Ukraine is to be upgraded to international standards within a reasonable timeframe.

99. **The policy recommendations outlined in this report are based on the assumption that long-term country objectives include modernization of the accounting and auditing professions, and development of a business environment conducive to preparation of transparent financial information compliant with international standards.** As set forth in this report, achievement of these objectives requires continuous reorganization and improvement of Ukraine's legal framework, institutions, accounting and auditing professions, as well as change in its business culture and education system. However, policies should not be developed and enacted without giving due regard to a country's ability to carry out such policies (both in terms of capacity and resources); a relatively lenient rule that is robustly and consistently enforced is preferable to a good, rigorous one that is unenforceable, as the lenient rule can be progressively made more rigorous as the circumstances allow. The policy recommendations below fall into three key areas:

- Statutory framework – these recommendations address each relevant Law, the normative basis of each Law and measures to assist implementation of each Law, in turn (refer to paragraphs 124-130);
- Institutional and capacity building measures (refer to paragraphs 131-139); and
- Professional education (refer to paragraph 140).

100. **These recommendations require a holistic approach to implementation.** Ukraine should establish a multidisciplinary National Steering Committee (NSC) to champion and coordinate the accounting and auditing reforms. The NSC should advise policymakers and regulators regarding the implementation of the recommendations. Based on the successful experience of other countries, this report recommends that the NSC develop a Country Strategy and a detailed Country Action Plan, which clearly sets out the key actions and allocates responsibilities for implementing the necessary reforms; the Plan should include a itemized budget indicating the resources necessary for successful implementation and the government, policymakers and development partners should work together to secure those resources so as to achieve the common goal of enhancing the quality and availability of financial information in Ukraine.

A. Statutory and Legal Framework

101. **In the past few years, the Ukrainian legal framework has been significantly updated, including introduction of the Civil and Commercial Codes, the Law on Banks, the Securities Law and the Law on Auditing.** However, further reform is needed in some key areas if the statutory framework for accounting and auditing is to conform to international best practice and be comparable to similar frameworks across Europe. Accordingly, this report mentions that the Ministry of Finance of Ukraine should continue to play the lead role in working with parliament and key regulatory institutions to amend the Laws and regulations as appropriate.

102. **This report recommends that the legislation be updated. The amendments to the Law should:**

- Introduce a definition of public interest entities (PIEs) which should include, as a minimum, publicly-traded companies, large financial institutions[36], and companies, which due to their size, in terms of number of employees, assets, and/or sales, have public accountability.
- Require the public interest entities to use IFRS in preparing their periodical financial information within a reasonable timeframe. All other entities should be given the choice of using IFRS or Ukrainian National Accounting Standards (NAS). Small and medium-sized enterprises (SMEs) should be allowed to take advantage of reduced accounting requirements appropriate to small and medium enterprises, which should be introduced into Ukrainian NAS.[37]
- Amend the definition for small and medium-sized enterprises, to include a balance sheet measure, such as gross assets.
- Require all PIEs to have their financial statements audited by statutory auditors in accordance with ISAs. Over a 5 year period other entities could be brought within the scope of a required audit, but the number of audits required should not exceed the potential capacity of the audit profession in Ukraine to provide ISA-compliant quality audit services.

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[36] As a side note, the capacity for insurance companies to operate as LLCs should be removed to ensure that all insurance companies are required to follow the rules as they apply to JSCs.

[37] Requiring all PIEs to apply IFRS goes beyond, in theory, the minimum requirements of EU Regulation (1606/2002), which requires listed entities to apply IFRS. However, almost all major financial institutions in the most EU member states are listed; in practice, PIEs in the EU generally apply IFRS.

- Require all PIEs to make their audited financial statements publicly available in a timely manner.
- Clarify the role and responsibilities of the NBU, SSCMC, SCRFSM regarding setting accounting requirements and monitoring and enforcing financial and regulatory reporting, namely reducing their role in setting the standards and requirements and strengthening their role in enforcement of not only regulatory reporting, but also general purpose financial reporting. Regulatory reporting should be in addition to and not in contradiction with the general purpose financial reporting required under the Law on Accounting.
- Increase the accountability of preparers of financial statements; define specifically, in law and practice, who is responsible for the probity of legal entity and consolidated financial statements. Specific enforcement measures in cases of infringement should be incorporated into appropriate legislative acts. This amendment may also require an update of current Company Law.

The implementation of many of the above recommendations will bring Ukraine's statutory framework into much greater alignment with the *acquis communautaire*, the body of EU law and regulations. The EU's Second, Fourth, Seventh and Eighth Company Law Directives and the Transparency Directive should be taken as examples to guide amendments to legislation, but the specifics of Ukraine's market must also be considered. The process of reform should be seen as part of the cooperation of Ukraine with the EU envisaged as part of the European Neighbourhood Policy, and support for the reform should be sought from the EU under this program.

103. **The implementation of the Law on Accounting should be assisted by a set of clear and coordinated measures including the following:**

- The Ministry of Finance (MoF), with the support of all relevant stakeholders, should draw up a workplan for assisting the implementation of IFRS by public interest entities. Many of the recommendations of this report may form part of this workplan. In addition, the MoF and the AMC should take measures to assist preparers of financial statements in the application of NAS, such as completing and updating methodological guidelines supporting such application.
- A large-scale training program should be designed and implemented for preparers of financial statements who will be required to transition to IFRS. Further recommendations on enhancing the education and training of accountants and auditors over the longer term are included below.

104. **The new Law on Auditing has made good progress towards adoption of international practices.** However, some further amendments should be considered, which would:

- Require that the registration of statutory auditors and audit firms be subject to requirements including compliance with ISA, qualification criteria and submission to quality control monitoring.
- Subject, over the medium to long-term, the registering body or bodies for auditors to independent public oversight which ensures bodies act in the public interest. The majority of those responsible for such public oversight should be non-practitioners of audit; a body compliant with the requirements of the recent amendments to the EU Eighth Company

Law Directive similar to the Professional Oversight Board in the UK could be established.

- Clearly separate the concept of an audit from other services that may be provided to a client by audit firms; the current definition of audit in the Law encompasses more than just audit activities.[38] The Law should require that fees paid for statutory audit and fees paid for other non-audit services provided by the auditor be disclosed in the financial statements.
- Involve the entity's shareholders in the contracting and approval of audit services and results. The introduction of such a provision would allow the expansion of the contractual relationship between the auditor and the entity, including the shareholders, not only the directors. The appointment of independent auditors and review of the auditor's report should be the responsibility of an audit committee; the current revision committee could become this audit committee, or assume its role. Introducing this requirement may also require an update of the current Company Law. Procedures ruling auditors' appointment, selection, dismissal and resignation should be clearly defined.
- Clarify the extent of the auditor's potential liability in the event of malpractice or negligence. In this, it should be made clear that the auditor's main liability is to the entities' shareholders, not to the management of the company.
- Require that auditors hold professional indemnity insurance sufficient to meet a reasonable level of potential claims arising from their auditor's work.

105. **Measures should be taken to support the implementation of the financial reporting requirements introduced by the new Law on Securities (2006), including the following:**

- The SSCMC should prepare and publish updated guidelines for the preparation of the placement prospectus and periodical financial information, taking into consideration provisions of the new Securities Law and other laws. The guidelines should focus on the application of IFRS and preparation of the required disclosures, including ownership and related parties disclosures. The SSCMC could consider creating a joint working group with the AMC of the MoF, when preparing these guidelines.
- The vetting and approval of prospectuses by the SSCMC should not result in that body accepting responsibility for either the completeness of the information contained in the document, or its conformity with the legislation. The placing of responsibility on the Commission for the completeness of information could be seen to inhibit the general requirement for companies and directors to be responsible for all information issued by a company.
- The existing list of information required by the stock exchanges (e.g. PFTS) should be reviewed and analyzed. Where the requirements repeat those of the Law on Securities they should be eliminated, to avoid duplication of disclosure required of issuers and thus an unnecessary regulatory burden. This report recommends reducing disclosure to a stock market to only that information which is necessary to enable it to fulfill its obligations as a stock exchange. This will, necessarily, result in the SSCMC being the sole regulator in areas where, at present, the stock exchanges may be perceived to have some responsibility.

[38] An auditor should not be precluded from providing other services as long as these do not constitute an independence threat or self-review threat, but these should be kept separate from the audit function.

B. Institutional and Capacity Building Measures

106. **All the regulators and institutions with responsibilities for aspects of the financial reporting process, including the NBU, SSCMC, SCRFSM and CoAU, face increasing challenges as the demand for high quality financial reporting grows and requirements for accounting and auditing become more sophisticated.** There is a consistent need for institutional and capacity building measures at each institution. The plans are likely to require the implementation of a coordinated capacity-building program, including staff internships in leading international professional associations and regulators, as well as the recruitment of personnel with appropriate accounting and auditing qualifications and experience. The funding required for this should where possible be covered through subscription/registration fees from regulated entities, charged to reflect the entities size and profitability. However, it is likely that some further financial assistance will be needed in the short to medium term, possibly from development partners or budgetary support.

107. **The CoAU should support the implementation of the new Audit Law (2006) through a set of clear and coordinated measures including the following:**

- An efficient and sustainable translation process should be established to ensure that the CoAU's translation of the latest ISA and the IFAC Code of Ethics into Ukrainian is readily available and affordable for all auditors in Ukraine.
- The CoAU should continuously review and update their Audit Manual to make it fully compliant with current ISA. The CoAU should act in coordination with the major regulators (NBU, SSCMC and SCRFSM) to develop sector specific audit guidance. Examples of application guidance from other jurisdictions, (where ISAs are mandated) may provide a starting point (e.g. Auditing Practices Board - Practice Notes in the UK and Ireland).[39]
- The CoAU should further develop and implement a comprehensive quality assurance system for audit; all statutory auditors and audit firms should be subjected to the quality assurance procedures within a defined timeframe. The procedures should be consistent across all quality inspections and the results of the quality assurance review should be instrumental in the CoAU's decision whether or not to continue the licensing of the audit firm, or issue it subject to restrictions and/or conditions.
- The CoAU should establish an effective system of investigations, conflict resolution and sanctions for potentially serious misconduct relating to statutory audit. 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 the requirements of the EU 8th Company Law Directive, which dictates practices in EU Members States, and IFAC's SMO 6, Investigation and Discipline.

108. **The National Bank of Ukraine's oversight capacity could benefit from increasing the cooperation between the commercial banks' external auditors and the supervision department of the NBU in accordance with the guidelines set forth jointly by the Basel Committee on Banking Supervision (BCBS) and the International Auditing and Assurance**

[39] An alternative, or possibly complimentary, solution would be to source a commercially available audit methodology that has been developed for other jurisdictions; this could be translated and made available for commercial purchase. Technical update and revision would become the responsibility of the commercial provider.

Standards Board (IAASB). In the past, this coordination has been hampered by weak capacity of the local auditors and low reliance placed on the results of their work. As capacity of the local audit profession grows, a higher level of coordination will become appropriate and mutually beneficial.

109. **The government should reconsider the SSCMC's mandate; currently, it is too broad to be effectively followed with around 35,000 public joint-stock companies under its authority[40].** At the same time, the SSCMC's role should be extended to make it explicitly responsible for reviewing the appropriateness of accounting policies adopted by entities within its scope and the compliance of those entities with applicable financial reporting standards.

110. **The SSCMC, NBU and SCRFSM should develop and implement a risk assessment system and adopt a risk-based supervision process.** This will enable each regulator to focus its limited enforcement resource on those areas where the effect of those resources will be greatest, such as economically significant or listed companies. In order to develop and implement such a system effectively, significant external assistance will be required.

111. **Enforcement capacity of the SSCMC, NBU and SCRFSM should be strengthened.** Where a material misstatement in the financial information is detected or submitted financial information does not follow set requirements, the regulators should be empowered to take timely and effective actions proportional to the impact of the detected infringement.

112. **The SCRFMS should continue to develop comprehensive methodological recommendations, giving specific financial reporting and accounting guidance applicable to the various types of NBFIs.** This guidance should address key financial reporting issues in insurance (e.g establishment of a claims database), non-state pension funds (reconciliations of funds received and paid, concentration limits), cooperation with auditors, regulatory requirements for key individuals in the reporting process (if appropriate), and training requirements and opportunities.

113. **The three professional accountancy organizations (UUOA, UFPAA and UACAA) should make a more coordinated effort to represent and include more of the auditors, accountants and preparers of financial information in Ukraine.** They should be supported in this, where possible, by the Government and other regulatory bodies. Possible steps could include the introduction of an associate membership stage, a very significant retraining and re-tooling program. Some potential mergers of professional organizations may be considered in the future. The organizations should offer training courses across Ukraine through their branch networks and could offer associate membership to those who complete courses. They could then seek to encourage associate members to complete further formal training so that they satisfy the criteria for full membership, thus increasing the capacity of Ukraine's accountancy profession.

[40] Even under most recent 2008 amendment of the JSC law, the public JSC is defined as one with more then 100 shareholders. This definition may not necessarily lead to a reduction in the number of regulated JSCs.

114. **The accounting profession will significantly benefit from introduction of a joint strategy of development, setting both short and long term objectives and assessing the resources needed for achieving the objectives.** While in the longer term, professional bodies should strive to be financially self-sustainable to the extent possible, should seek twinning opportunities with other European accounting bodies and continue to work with development partners where appropriate.

C. Professional Education

115. **In parallel to improving the statutory and institutional framework, there is a strong need to improve the capacity of the accounting and auditing professions.** The genuine understanding and adoption of national and international accounting, financial reporting and auditing standards and requirements requires relevant education and training for financial statement preparers, auditors, and regulators. In this regard, it is essential to enhance the capacity of existing accountants as well as ensure the capacity of future accountants. Measures, or, where appropriate, legislative changes should include:

- A major program to re-tool existing accountants. "Chief accountants" and other preparers of financial statements in Ukrainian companies should be encouraged to improve their understanding of NAS, IFRS (where appropriate) and the key principles of their application within the financial reporting framework in Ukraine. Companies should also be encouraged to support employees' training and study towards modern accountancy qualifications. On the supply side, accountancy education centers, sponsored by the professional accounting organizations, the CoAU and the private sector could be opened or enhanced through specific measures.[41] It is important to make sure that their offering will be tailored to the needs of Ukrainian companies. In most companies, much of the finer detail of IFRS will be irrelevant. The core concepts, such as principles-based accounting, the need for accounting estimates, the separation of tax and financial reporting and the interaction of financial statements, management accounting and cash flow accounting, should be central to the education of the profession.
- Professional accounting organizations and regulators should encourage qualifications which 'chief accountants' and other accountants in industry and the public sector would aspire to, which would be affordable and within their capabilities. The absence of such intermediate qualifications risks disenfranchising the majority of the current accountancy profession in Ukraine. The Russian-language Certified Accounting Practitioner (CAP) qualification appears to be the most appropriate basic qualification currently available in Ukraine; it could be beneficial if this qualification is held by accountants in relevant government departments, regulators, State-Owned Enterprises and academia and as a prerequisite for auditors. However, in the longer term a Ukrainian-language qualification should be developed.
- Updating and, in some cases, redesigning accounting syllabi and training programs in vocational and academic education to cover IFRS, NAS and the future needs of the Ukraine profession. In order for the accounting reform process to be sustainable in the longer term, it is essential that university accountancy courses are designed to ensure that future accountants become thoroughly proficient in the matters of accounting, financial reporting and auditing, based on the best international practices. The curricula for

[41] A good example of the orchestrated effort in this field was the Accountancy Training Program, sponsored by the EU TACIS project. The two-stage program included 'train the trainers' and 'train the practitioners' components and received very positive feedback from its participants.

accountancy and business courses at many universities in Ukraine need to be significantly updated. The Ministry of Education (MoE) should work with the regulators and the leading universities to design courses, based on IFRS/ISA, which will:

- Develop within students the intellectual and imaginative skills required to critically understand fundamental concepts;
- Provide practice-oriented teaching with stronger focus on business administration and case studies to best prepare professional accountants (rather than bookkeepers or tax compliance officers);
- Include instruction on the ethical dimensions of business management, finance, accounting and auditing;
- Gain significant exemptions in the professional certification programs for auditors and accountants offered by established accounting bodies as agreed by the Chamber of Auditors; and
- Promote high quality research both for its own sake and as support for teaching.

- Significant strengthening of the capacity of university faculties which teach accountancy. A major program of updating such staff members' skills in international best practice accountancy, including IFRS and ISAs, is needed to achieve these changes. The MoE need to ensure that sufficient up-to-date training and reference materials (such as local-languages copies of IFRS, NAS and ISA) are available to students and faculty members alike.
- Seconding key operational staff from the regulatory and supervisory agencies to similar agencies abroad for 'on the job training' on best international practices regarding monitoring and supervision in the regulators' respective areas, as well as IFRS.
- Ensuring that national professional certification programs in the area of accounting and auditing comply with the internationally recognized practices, and in particular draw upon International Education Standards established by the International Accounting Education Standards Board (IAESB) of IFAC. Relevant IES include IES 6, Assessment of Professional Capabilities and Competence, IES 5, Practical Experience Requirements and IES 8, Competence Requirements for Audit Professionals.
- Promoting and articulating CPD requirements which are consistent with IFAC requirements. The professional organizations should not be the exclusive provider of training courses to its members, but should ensure that members maintain sufficient theoretical knowledge, professional skills and values in order to retain their certification.