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

ACCOUNTING AND AUDITING

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Executive Summary

In the recent past, the Colombian government, with the approval of Congress, has embarked on new strategies to advance structural economic reforms and macroeconomic stability, reform the regulatory institutions and systems of control, and improve law and order. One of the government's reform proposals involves a project to improve the corporate financial reporting regime. This project includes enacting a new law to reform and develop the accounting profession, fully adopting International Accounting Standards (IAS) and International Standards on Auditing (ISA), implementing international best practice on a professional accountants' code of ethics, and establishing an internationally comparable arrangement to license public accountants.

This report is prepared on the basis of the findings of a review of accounting and auditing standards and practices in Colombia. The review exercise focused mainly on the strengths and weaknesses of the institutional framework that supports a corporate financial reporting system in the country. The current legal and regulatory requirements on accounting have led to issuance of conflicting accounting standards from multiple sources. Legal arrangements that gave various regulatory bodies the right to determine the accounting requirements for entities falling under their jurisdiction have led to the predominance of special-purpose financial reporting. In practice, there is no operational concept of general-purpose financial reporting. The legislative requirements on auditing contradict the modern concept of financial statements audit. In reality, there is no external financial statements audit requirement in Colombia. There are sufficient problems with the capacity and regulation of the accountancy profession that the existing profession cannot be the basis for the independent financial statements audit function.

This report provides policy recommendations to improve accounting and auditing practices, including strengthening enforcement mechanisms to ensure compliance with accounting and auditing requirements and a professional code of ethics for auditors. In this context, it is recommended that a statutory regulatory body be established. Other policy recommendations include the creation of a Higher Council that would be responsible for issuing IAS and ISA as local mandatory requirements for public interest entities; establishment of a new professional organization for auditors of financial statements; reformation of accounting curriculum and significant improvements in teaching capacity of accounting instructors at universities; and organization of training programs on practical aspects of IAS and ISA for accountants, auditors, and others.

This report was prepared by M. Zubaidur Rahman (OPCFM) and Luis Schwarz (LCR) of the World Bank on the basis of the findings from a diagnostic review carried out in Colombia in April and May 2003. The review was led by the country authorities, and was conducted through a participatory process that involving various stakeholders.

I. INTRODUCTION

1. The review of accounting and auditing practices in Colombia is a part of the World Bank and the International Monetary Fund (IMF) joint initiative on Reports on the Observance of Standards and Codes (ROSC). The review focused on the strengths and weaknesses of the accounting and auditing environment that influences the quality of corporate financial reporting, and covered both requirements and actual practices. It used the International Accounting Standards (IAS)¹ and the International Standards on Auditing (ISA) as benchmarks.

2. Colombia has a broad mineral and agricultural resource base, an educated and skilled labor force, a modern manufacturing and consumer economy, and a democratic political system. Over 400 multinational companies in Colombia are successfully expanding their businesses, despite insurgencies and armed conflict. Of the 139 companies listed in the Colombian Stock Exchange, 109 are equity and debt issuers, and 30 are debt issuers only. The volume of trading is approximately US\$2 million per day, with a total capitalization of about US\$17 billion; however, market liquidity is a major concern. The 1997-99 recession, which came after more than 40 years of steady growth, was the worst in 70 years. Colombia's economy was hit hard, but today it has largely recovered.

3. Despite its problems, Colombia ranks solidly among the countries that are committed to implementing international best practices to strengthen the underpinnings of their market economies. To reactivate the economy, gain public confidence in the capital markets, and attract domestic and foreign investors, the current government with the approval of Congress has embarked on new strategies to advance structural economic reforms and macroeconomic stability, reform the regulatory institutions and systems of control, and improve law and order. One of the government's reform proposals involves a project to improve the corporate financial reporting regime; it includes enacting a new law to reform and develop the accounting profession, fully adopting international accounting and auditing standards, implementing international best practice on a professional accountants' code of ethics, and establishing internationally comparable arrangements to license public accountants.

¹ In this report, the term International Accounting Standards refers to all standards and related interpretations issued by the former International Accounting Standards Committee (IASC) and the International Financial Reporting Standards (IFRS), and related interpretations issued by IASC's successor body, the International Accounting Standards Board (IASB).

II. INSTITUTIONAL FRAMEWORK

A. Statutory Framework

4. **The country's legal and regulatory requirements on accounting are not conducive to high-quality financial reporting.** Colombia has multiple legally established sources of accounting standards and rules, and some of the accounting requirements conflict with each other. As a result, preparers and auditors are often confused about the applicability of particular accounting treatments and disclosure obligations, and the quality of financial statements suffers. The legal requirements on accounting can be found in (a) the Code of Commerce, which sets forth the general accounting requirements that commercial enterprises must follow in maintaining books of account, recording transactions, and preparing financial statements; (b) Law 43 of 1990, which provides a general legal framework authorizing the government to issue detailed Colombian accounting and auditing standards, and to regulate the practice of public accounting as a profession; and (c) Decree 2649, which promulgates Colombian generally accepted accounting principles (Colombian GAAP). In addition to these sources of accounting requirements, various government agencies and regulatory bodies issue Chart of Accounts and accounting instructions. Law 222 of 1995 empowered various regulatory bodies (called *Superintendents*) and other government entities to issue accounting rules for the entities they supervise. The Superintendent of Corporations (corporate regulator), the Superintendent of Securities (securities market regulator), and the Superintendent of Banking (regulator of banks, insurance companies, and pension funds) are most active in issuing accounting rules.

5. **The accounting rules issued by the tax authorities influence the accounting policies used in preparing the annual audited financial statements for external users.** Law 222 of 1995 provides tax authorities, known as DIAN (*Dirección de Impuestos y Aduanas Nacionales*), with legal authority to issue accounting rules. Because taxation authorities ensure that those who record and report specific financial information follow their accounting rules, tax accounting plays an important role in the preparation and audit of the annual financial statements of an enterprise. Since certain transactions are recorded in the books of account on the basis of tax, this affects the information produced in the annual audited financial statements. Unfortunately, the tax accounting rules are generally not consistent with the Colombian GAAP or with internationally accepted accounting principles. In many cases, tax accounting rules require accounting treatments that conflict with financial reporting requirements in such areas as inventory costing, valuation of inventories under the retail method, accounting for leasing contracts, depreciation of fixed assets, provision for bad debt, and inflation adjustments. To avoid triggering a difference of opinion and misunderstanding with the taxation authorities, both preparers and auditors of such financial statements tend to favor the accounting policies that were used to determine taxable profits. As a result, users of financial statements may not always receive market-oriented information from the published financial statements.

6. **Banks are required to follow the same accounting standards/rules for both prudential regulatory reporting and financial reporting for external users.** For prudential regulation of banks, the Superintendent of Banking issues specific accounting rules, valuation methods, and disclosure requirements that are applicable not only to regulatory reporting purposes but also to those who prepare general-purpose financial statements. Insurance companies are required to follow accounting requirements issued by the Superintendent of Banking under Law 510 of 1999.

7. **Various laws mandate the preparation and presentation of annual audited consolidated financial statements.** The Code of Commerce and Law 222 of 1995 require enterprises, which own more than 50 percent of the capital of other enterprises, to prepare consolidated financial statements in accordance with Colombian GAAP. The Superintendent of Banking issued Circular No. 100 that requires banks to prepare consolidated financial statements. The Superintendent of Securities issued Circular No. 1 of 1996 that requires listed companies to prepare consolidated financial statements. Because of some shortcomings of these legislative requirements, banks do not consolidate the financial statements of nonbanking subsidiaries, and vice versa.

8. **There are additional reporting requirements to the Superintendent of Securities for listed companies.** Quarterly consolidated financial statements, including the notes and opinion of the auditor, must be submitted to the Superintendent of Securities no later than 30 days after the end of the period—except for the period ending in December—for which the statement must be submitted by March 1 of the following year. Superintendent of Securities must also receive in the prescribed format any changes in accounting policies; changes in amounts reported in previous financial statements; significant changes in assets; significant changes in the components of equity; payment of dividends; restructuring of liabilities; change of auditor; and reorganizations, mergers, and acquisitions.

9. **A majority of business enterprises meet the criteria for which they are legally required to appoint a *revisor fiscal* for conducting the annual audit.**² Article 203 of the Code of Commerce and Article 13 of Law 43 of 1990 provide the following criteria for determining the threshold of the annual audit requirement: all registered corporations; branches of foreign business entities; legal entities in which all the owners do not participate in management, and nonparticipating owners holding at least 20 percent equity; and all other commercial entities with total assets at December 31 of the prior year equal to or exceeding 5,000 times the minimum salary, and/or the gross income for the prior year equal to or exceeding 3,000 times the minimum salary.³ Article 20 of Law 45 of 1990 requires appointment of a *revisor fiscal* by all enterprises that are supervised by the Superintendent of Banking and the Superintendent of Securities, and more than 20 other laws require specific types of enterprises to appoint a *revisor fiscal*. Article 204 of the Code of Commerce requires the appointment of a *revisor fiscal* by majority vote of the shareholders at the annual general

² Some people translate the term *revisor fiscal* as “statutory auditor.” According to internationally accepted practice, the term “statutory auditor” is used to mean independent auditors who audit financial statements. Since a *revisor fiscal* is legally required to perform various activities that do not resemble auditing of financial statement, the term *revisor fiscal* is used throughout this report to mean those practitioners who perform legally required annual audits in Colombia.

³ The government determines minimum salary.

meeting. The law requires an individual public accountant to perform the duties of *revisor fiscal* and states that no person may be *revisor fiscal* for more than five companies at a time. If a public accounting firm is appointed *revisor fiscal*, a firm partner or employee who is legally qualified to practice accounting is designated to perform the duties of *revisor fiscal*. The appointment of *revisor fiscal* lasts for the same period of appointment as the board of directors, unless the *revisor fiscal* is removed sooner by simple majority vote of the shareholders.

10. **The functions of revisor fiscal are not compatible with the functions of an independent auditor of financial statements.** In Colombia, the modern concept of independent audit does not exist in legal provisions on audit. The laws require a *revisor fiscal* to carry out many activities, of which only one is expressing opinion on the financial statements. Applicable laws and regulations require a *revisor fiscal* to certify that the enterprise's internal control system is effective—thus the auditor is virtually made responsible for the client's internal control. The *revisor fiscal* is also required to safeguard the enterprise's assets and ensure that all the enterprise's obligations to various government agencies (including tax administration) have been met in a timely way. The government has delegated responsibility to the *revisor fiscal* for controlling and analyzing an enterprise's operations, and exercising vigilance over and inspecting all transactions. Thus, in effect, it requires an enterprise's auditor to conduct controllership functions that should be the responsibility of management. These activities impede an external auditor's independence as outlined in the auditor independence rules promulgated by the International Federation of Accountants (IFAC).

11. **The laws hold an enterprise's top management and board of directors responsible for misrepresentations in the financial statements.** Law 222 of 1995 highlights the responsibility of enterprise management but provides no sanctions or penalties for noncompliance with regard to mandatory accounting and financial reporting standards and rules. Although the existing legislation permits shareholders and owners to bring legal action against management in civil court, they rarely do.

12. **The legal entity's annual audited financial statements need to be approved at the annual general meeting of shareholders.** The Code of Commerce requires that the annual financial statements of all legal entities need to be approved at the annual shareholders' meeting. Article 84 of Law 22 of 1995, which was reaffirmed by Decree 3100 of 1997, requires all commercial legal entities to file a complete set of annual audited financial statements with the Superintendent of Corporations. And, according to Article 41 of Law 222 of 1995, all commercial legal entities are required to file their annual audited financial statements with the Chamber of Commerce of the area where the entity is registered.

13. **Enterprises are required to publish an annual balance sheet and income statement in a national newspaper.** Both the Superintendent of Banking and the Superintendent of Securities require enterprises to publish a balance sheet and income statement, without explanatory notes, in one of the widely circulated daily newspapers within 10 days after approval by the general assembly of shareholders. Since the supporting explanatory notes are not published, it is possible that users may misinterpret and misunderstand the numbers in these documents. The reader is not cautioned about the

summarized information in the published documents. For a full understanding of the enterprise's financial position and the results of its operations, the published information should be read in conjunction with the full set of audited financial statements (including all disclosures required by the relevant financial reporting framework). Recently, the Superintendent of Securities has issued a ruling that requires regulated enterprises present a full set of financial statements suitable for posting on the Superintendent's website. Enterprises have not yet complied with this requirement.

14. **Law 43 of 1990 authorized the creation of a Central Board of Accountancy (CBA) under the Minister of Education to regulate the public practice of accounting and auditing in Colombia.** The decision to put the CBA under the Ministry of Education reflects the fact that an academic degree, irrespective of its quality, is a passport for entry into the profession; and additional professional qualification is not required for registration as a public accountant. Accountancy in Colombia appears to be an accredited rather than a properly licensed profession; and the regulatory focus is more on entry to the profession than on performance once admitted. The CBA maintains a register of public accountants and has power to impose sanctions on registered public accountants who violate legal requirements. However, in practice, this body does not have a mechanism to monitor and enforce accounting and auditing requirements.

B. The Profession

15. **The Central Board of Accountancy lacks adequate capacity to function as an effective regulator of the accountancy profession.** The Board comprises 11 appointed members: 7 from the government, 2 from public accountants, and 2 from universities. In 2002 the CBA reviewed 174 cases for potential violation of the accounting and audit regulations by registered public accountants, but only 2 ended in actual sanctions. The CBA is underbudgeted and is perceived to lack the capacity to discharge the duties provided by law.

16. **Because entry into the accountancy profession is easy, Colombia has many registered public accountants.** Professional qualification examinations are not a prerequisite for registration as a public accountant. The CBA issues a *Public Accountant* license to applicants who have successfully completed the university degree (bachelor's degree) in accounting and have gained one year of accounting-related work experience after university graduation. Applicants do not need to pursue practical training under the supervision of a qualified public accountant. A registered public accountant who neither took a professional qualification examination nor gained any relevant professional experience is allowed to work as a *revisor fiscal* of enterprises of all types and sizes, including publicly traded companies, banks and similar financial institutions, and insurance companies. In practice, many public accountants in Colombia start their career with inadequate professional knowledge and skills. At present there are about 110,000 registered public accountants with an expected 100,000 or more to be licensed to practice during the next five years. According to the National Chamber of Commerce, the supply of registered public accountants in Colombia exceeds demand by about 100 percent.

17. **There are more than 120 accounting associations.** University students who intend to join the accounting profession become members of one or more accounting associations and continue their membership throughout their professional careers. These associations are members at the national level of two major organizations that function like trade bodies—the Confederation of Institutes of Public Accountants and the Federation of Collegiums of Accountants. Another organization, which resembles a professional accounting body, is the National Institute of Public Accountants of Colombia (INCP). The INCP has been in existence for 50 years and is a member of IFAC. It has about 700 members, including the four largest accounting firms and their staff and partners.

18. **The law does not require auditors to hold professional indemnity insurance.** Professional indemnity insurance is available in Colombia through insurance companies; however, few auditors outside the large accounting firms purchase it. Although a legal provision exists specifying the auditor’s liability (contractual, civil, and/or criminal) for certain misconduct when discharging professional responsibilities, this provision has not been tested.

19. **Registered public accountants are not required to follow a code of ethics comparable to the one issued by IFAC.** The requirements on professional ethics can be found in a few articles of Law 43 of 1990, but do not include guidelines on independence principles. There is a large gap between these requirements and the prescriptions in the IFAC Code of Ethics for Professional Accountants (revised in November 2001). Because the requirements are included in the law, it is difficult to update them to reflect changes in the IFAC Code. It would be easy to reduce the gap if the law would empower a body to issue a code of ethics for observance by all registered public accountants. The National Institute of Public Accountants has recently adopted the IFAC Code for its members—but compliance is voluntary.

C. Professional Education and Training

20. **The academic accounting curriculum should be reformed to facilitate implementation of high-quality accounting and auditing standards.** University curricula lack modern theories and practices of accounting and auditing, practical application of IAS and ISA, and business ethics. University accounting and auditing instruction concentrates on the legal requirements for, and the techniques of, recordkeeping and reporting to meet obligations to the tax administration and other statutory authorities. Auditing instruction focuses on the legal obligations of the *revisor fiscal*, including audit verification techniques, examination of all transactions from the perspective of financial control, and various legally required compliance work that the *revisor fiscal* must carry out on behalf of enterprise management. At present, academic programs in accounting are geared toward producing technicians, not modern accountants and auditors; as a university teacher commented, “We focus more on teaching bookkeeping than accounting.”

21. **The quality of teaching accounting and auditing should be significantly improved.** Of the 120 higher education institutions that offer bachelor's degree-level accounting programs, only 4 programs are considered to be of relatively high quality. The scarcity of qualified accounting instructors contributes to the deteriorating quality of accounting education in Colombia. Many instructors in accounting and auditing lack adequate knowledge of modern theories and practices; thus important subjects are either not taught or are poorly taught. There is also a lack of capacity in Colombian higher education institutions for teaching the practical application of accounting and auditing standards issued by IASB and IFAC.

22. **Adequate practical experience should be a prerequisite for a practice certificate.** The absence of practical experience requirements in line with IFAC's pronouncements on professional education and training has contributed to the weakness of the profession in Colombia. A candidate needs to gain adequate practical experience under direct supervision of an experienced member of the professional body. Arrangements should be made to ensure that the practical training providers possess adequate capacity to help trainees learn the practical dimensions of internationally accepted auditing standards and procedures.

23. **Licensed public accountants are not required to pursue continuing professional education.** Contrary to the IFAC's pronouncements and to generally accepted international best practice, practicing accountants and auditors in Colombia are not required to take continuing professional education. This weakness underscores the shortcomings of the professional education and training system in the country.

D. Setting Accounting and Auditing Standards

24. **Under the Colombian Constitution, only Congress has the authority to issue generally accepted accounting principles (GAAP).** Congress can delegate this authority to the executive branch and other institutions through an act of law. Law 43 of 1990 created the Technical Council for Public Accounting under the Central Board of Accountancy to issue technical guidance on accounting standards. The Council developed a set of accounting principles that they termed Colombian GAAP. The President of Colombia issued Decree 2649 of 1993, which mandated Colombian GAAP as the accounting standards for all enterprises in Colombia. And in Law 222 of 1995, Congress allowed governmental agencies and regulators to issue the accounting standards necessary to perform their regulatory duties. At present there are approximately 43 different sets of accounting standards in Colombia, including those issued by the Superintendent of Banking and the Superintendent of Securities.

25. **Colombian GAAP was developed by the Technical Council in early 1990s on the basis of U.S. GAAP and International Accounting Standards.** Colombian GAAP is not consistent with the U.S. GAAP and other international standards. For example, several accounting standard areas, which are presented in detail over many pages under U.S. GAAP or IAS, are shortened to only basic provisions but no substantive directions in brief paragraphs under the Colombian GAAP. Disclosure is not addressed at all in the Colombian GAAP. The Technical Council has not updated Colombian GAAP to reflect changes in U.S. GAAP and IAS since 1993.

26. **There are no legally binding financial statement audit standards in Colombia.** Law 43 of 1990 requires the *revisor fiscal* to conduct work in accordance with Colombian GAAP, but it does not specify any other auditing standards or procedures. It provides only one page of general guidance on auditing requirements. The absence of auditing standards for financial statement audit reflects the fact that Colombian law recognizes the work of the *revisor fiscal* only. There is no concept of independent audit of financial statements. No law has yet been passed to streamline the legal framework regarding development and issuance of auditing standards.

E. Ensuring Compliance with Accounting and Auditing Standards

27. **Regulators concentrate more on issuing than on enforcing accounting standards.** The regulatory bodies lack capacity to monitor compliance with accounting and financial reporting requirements, and have not put in place an efficient and effective mechanism to monitor and enforce accounting and auditing requirements. The Superintendent of Corporations has a department responsible for reviewing the financial statements filed by all commercial legal entities in the country. In practice the reviewers rarely identify real violations of the accounting and reporting requirements. Effective enforcement actions are never imposed. The other regulatory bodies generally use their resources to monitor compliance with legal formalities; rather than to review financial reporting practices to determine noncompliance with the applicable standards and rules.

28. **The securities market regulator and the regulator of financial institutions sometimes identify violations of accounting and auditing requirements as by-products of monitoring and enforcing prudential regulations.** In the course of supervising and monitoring compliance with prudential regulations by banks, insurance companies, and pension funds, inspectors of the Superintendent of Banking will take action if they uncover violations of accounting and auditing requirements. Officials of the Superintendent of Securities take similar actions if they uncover violations of accounting and auditing requirements in the course of their market surveillance and other supervisory activities. The Superintendent of Banking and the Superintendent of Securities are authorized under the Banking Law and the Securities Law, respectively, to impose administrative sanctions against violators, including monetary penalties and suspension or disbarment of advisors and auditors. In practice, when regulators uncover material errors or infractions, the standard procedure is to arrange a meeting with the *revisor fiscal* and request a correction of the financial statements, without investigating the nature, extent, and impact of the errors or infractions. Effective punitive actions are rarely taken; the strongest sanction to date has been the issuance of a letter of reprimand.

29. **There is no organization responsible for ensuring that practicing auditors observe high-quality auditing standards and the professional code of ethics.** The National Institute of Public Accountants of Colombia, like other national professional organizations, has no mechanism to ensure its members' compliance with any auditing standards and code of ethics. The law has not yet established a statutory regulatory body to review the auditors' practices and enforce auditing requirements.

III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

30. **The Colombian GAAP issued by Decree 2649 of 1993 has the status of national accounting standards.** The accounting rules issued by various regulators were intended to supplement the Colombian GAAP. However, in practice, the regulators have issued many accounting rules that contradict the requirements of the Colombian GAAP, giving rise to problems for preparers and users of financial statements. The most frequent problem, though not unique to Colombia, is the pervasive influence of tax authorities on the choice and application of accounting principles. The problem is aggravated by the tendency of regulators and governmental entities to issue accounting standards, creating confusion for preparers and users of financial information and damaging the transparency and market-oriented usefulness of the financial statements.

31. **There are many differences between Colombian GAAP and IAS.** Colombian GAAP fails to incorporate many areas covered by IAS. And the Colombian GAAP has not been updated to reflect IAS requirements since 1993, when Decree 2649 was enacted. Moreover, because the Colombian GAAP only briefly covers some complicated accounting issues, different parties interpret accounting and reporting requirements in different ways, exacerbating the large gap between Colombian GAAP and IAS. Examples of differences in Colombian GAAP follow:

- Lacks guiding principles on inventory valuation and related disclosures;
- Fails to discuss accounting for construction contracts;
- Provides contradictory approaches to recognizing deferred taxation;
- Does not cover segment reporting requirements; and
- Lacks clear-cut accounting rules and detailed disclosure requirements in such other areas as finance leases, employee benefits, foreign currency transaction and translation, business combinations, investments in associates and joint ventures, earnings per share, provisions and contingencies, and financial instruments.

32. **There are also differences between Colombian GAAP and the banking regulator's accounting rules.** The following are some requirements promulgated by the Superintendent of Banking that conflict with the requirements of Decree 2649 (Colombian GAAP):

- Inflation adjustment was repealed as of January 1, 2001.
- Nonfinancial subsidiaries should not be consolidated with the financial subsidiaries.
- Tax rules should be followed in accounting for leases.
- Specific methods should be followed for the recognizing, measuring, and disclosing financial instruments.
- Accounting for investments should use the fair value method.
- Deferred tax accounting is permitted in limited circumstances.
- And expenses should be deferred under certain circumstances.

33. **There are also differences between Colombian GAAP and the accounting rules issued by the securities market regulator.** The following are examples of differences between the accounting rules under Decree 2649 and those required by the Superintendent of Securities:

- Adjustment for inflation must be applied in an integral manner and not as required under Decree 2649 for just inventory, and prior year financial statements must be restated at current year prices.
- Disclosures of segment information and discontinued operations are required.
- The determination of whether a leasing contract is an operating lease or financial lease is dependent on the treatment under the tax rules with reference to the amount of assets at the beginning of the year.
- Under specific circumstances, certain expenses should be deferred.
- Specific guidelines are provided on valuation of investments at market price.

34. **The review of 20 samples of financial statements of listed companies revealed shortcomings in actual compliance with a number of applicable accounting requirements.** The checklist for this ROSC review was prepared on the basis of the accounting requirements under Colombian GAAP and accounting rules issued by the securities market regulator. The review found compliance gaps in several areas:

- ***Disclosure of accounting policies.*** Many companies did not disclose the required accounting policies in various areas, including consolidation, deferred expenses, valuation of assets, inventories, earnings per share, and provisions for bad debt.
- ***Accounts receivable.*** Some companies did not show the provision for bad debts on the income statement and balance sheet, as required under Colombian GAAP and the accounting rules of the securities market regulator.
- ***Inventories.*** Some financial statements did not disclose the method of inventory valuation. The provision for obsolete and slow-moving inventory was not reported by any sample companies.
- ***Shareholders' equity.*** Many companies did not disclose the number of shares authorized, issued, and fully paid-in, and issued and not fully paid-in. Also, there was no mention of the rights, preferences, and restrictions attached to the class of share, including restrictions on distributions of dividends and repayment of capital.
- ***Consolidated financial statements.*** Some companies did not prepare consolidated financial statements in accordance with the requirements of the securities market regulator and the Colombian GAAP. Investments in subsidiaries were reported using the equity method of accounting.
- ***Related-party relationships and transactions.*** Few companies that had related parties provided full information on related-party relationships and transactions in their financial statements. Most companies did not disclose the volume of transactions, outstanding amounts, or the pricing policies to determine arms-length dealings among the related parties.

- **Financial instruments.** Several companies did not disclose required information for each class of financial asset, both recognized and unrecognized, including information about the company's exposure to credit risk. Many also failed to comply with various other disclosure requirements relating to financial instruments.
- **Earnings per share.** Several financial statements failed to report earnings per share.
- **Employee benefit costs.** Several companies did not disclose the accounting policy used to account for employee benefit costs, or the legal nature and terms of the employee benefit costs, including vesting provisions, actuarial gains and losses, and the amounts recognized in the financial statements.
- **Taxation.** Most financial statements did not report deferred taxes in the balance sheet.
- **Effects of changes in foreign exchange rates.** Several companies did not recognize differences arising on the settlement of monetary items or on reporting the company's monetary items at rates different from those at which they were initially recorded, as income or expense in the income statement.
- **Events after the balance sheet date.** Most companies failed to report information pertinent to events subsequent to the balance sheet date.
- **Restriction on fixed assets, contingent liabilities, and provisions.** Most companies failed to provide information concerning restricted fixed assets that had been pledged as security, or the existence of contingent liabilities and provisions.

IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

35. **There are no auditing standards in Colombia to set the requirements and guidelines for auditing financial statements.** In two pages of general terms, Article 7 of Law 43 of 1990 describes the generally accepted auditing standards (Colombian GAAS) that Colombian auditors must follow when acting as *revisor fiscal*. Since the functions of *revisor fiscal* are different from those of a financial statements auditor, Colombia has no effective standards for the independent audit of financial statements.

36. **Practicing auditors generally follow the Colombian auditing requirements.** Since there are not many auditing requirements under Law 43 of 1990, compliance with these requirements does not appear to be a problem. However, a problem arises with respect to the standards followed in issuing a report on financial statements. As part of performing the task of a *revisor fiscal*, an auditor prepares and presents a report on the financial statements. This report is unlike the audit report in the case of a financial statements audit.

37. **In many cases, the audit reports issued by *revisors fiscales* show noncompliance with Colombian legal requirements on audit.** As a part of discharging professional duties for a client, a *revisor fiscal* issues an audit report on client's financial statements. A number of such audit reports reviewed in connection with the Accounting and Auditing ROSC showed various deficiencies with reference to the Colombian requirements, for instance:

- The auditor did not state under which generally accepted auditing standards the audit of financial statements was conducted and under which generally accepted accounting principles the financial statements were prepared;
- The auditor did not express the level of responsibility assumed for prior year financial information, presented on a comparative basis, when that work had been carried out by other auditors and expert appraisers. In one instance, the prior period auditor's opinion was modified without additional audit work to justify the change.

38. **Many important ISA elements are ignored when the objective of the audit is to express an opinion on the financial statements.** In addition to acting as *revisor fiscal*, some auditors carry out external audit of the financial statements of some of their clients. These external audits are not legally required; however, the clients treat this contractual audit as a value-added service. Many of these external audits have such shortcomings:

- Inadequate attention to maintaining the auditor's independence,
- Weak planning and performing of audit procedures,
- Inadequate documentation,
- Lack of proper focus on fraud and error,
- Inadequate knowledge of the client's business, and
- Maximum reliance on management's representations regarding related-party transactions.

V. PERCEPTION OF THE QUALITY OF FINANCIAL REPORTING

39. **Stakeholders expressed concerns about the deteriorating quality of corporate financial reporting caused by the confusion arising from multiple sources of accounting standards.** Interviews and discussions with various stakeholders—including foreign banks, international rating agencies, banking regulators, securities market regulators, stock exchange staff, academics, and some experienced audit practitioners—addressed the issues of perception of the quality of financial reporting. Lack of enforcement was identified as an important factor constraining high-quality financial reporting. There was a general consensus that university-level education in accounting needed significant improvements to prepare future accountants and auditors for the modern business world. Several foreign investors and stock market players emphasized that inadequate disclosure of relevant issues (such as segment reporting; consolidated financial statements; interests in joint ventures; provisions, contingent liabilities, and contingent assets; related-party transactions; financial instruments; and deferred taxes) adversely affects the usefulness of financial statements. (This adverse affect was not offset by the tendency to supply too much information on some less important issues.) All parties agreed that the preparation of general-purpose financial statements is

heavily influenced by tax reporting requirements. In addition, the absence of a modern auditing concept and the threat to auditors' independence from the legal responsibilities of the *revisor fiscal* have given rise to serious concerns about the quality of auditing in Colombia.

VI. POLICY RECOMMENDATIONS

40. The following policy recommendations reflect the inputs of various stakeholders, including senior accounting practitioners, government officials, representatives of regulatory authorities, leaders of accounting professional associations, investors, and academics. The policy recommendations aim to improve the corporate financial reporting regime in Colombia. It is expected that these policy recommendations would be used as inputs for preparing and implementing a Country Action Plan. Some policy recommendations—for instance, enactment of laws—need to be addressed immediately; others, such as those that involve institutional capacity building, need to be addressed over a medium to long term.

41. **Take immediate steps to enact a new law dealing with accounting, auditing, corporate financial reporting, and the accountancy profession in the country.** The new law should provide legal backing for a robust platform of general-purpose financial reporting and independent audit of financial statements that regulators can rely upon. If regulators require something more, they can then mandate simple reconciliation or supplementary disclosures for their regulatory purposes. The purpose of the proposed new regulatory framework is to reduce the impact of the current multiplicity of reporting frameworks, not to add to them. The Code of Commerce and other relevant laws should be amended by deleting the current provisions that deal with accounting and auditing. Thus only one law would deal with issues relating to accounting and auditing, and it would be easier to update accounting, auditing, and financial reporting requirements from time to time.

42. **Establish a Higher Council responsible for issuing accounting and auditing standards.** The new law should include provisions empowering a Higher Council to issue accounting and auditing standards that would replace all accounting and auditing standards and rules issued by any other body for application in general-purpose financial statements. The governing board of this Council should include senior-level representatives of relevant departments/agencies and regulatory bodies—for example, the tax administration, the securities market regulator, the regulator of banks and insurance companies, and the accountant general. The Council should develop adequate capacity to carry out the following activities:

- **Enforce IAS and ISA.** The law should include appropriate provisions to allow the Higher Council to officially adopt IAS/IFRS and related interpretations issued by the IASB as legally enforceable standards applicable to the preparation of the legal entity and consolidated financial statements of all public interest entities.⁴ The

⁴ Public interest entities may be defined by the nature of their business, their size, and their number of employees; or by their corporate status by virtue of their range of stakeholders. Examples of public interest entities might include banks, insurance companies, investment funds, pension funds, listed companies, and large enterprises. The large enterprises may be defined as follows: individual enterprises and groups of enterprises that meet two of three following thresholds should be considered as public interest entities—(a)

audit of financial statements prepared by public interest entities should be carried out in accordance with ISA and other related pronouncements issued by IFAC. Only public interest entities should be subject to annual mandatory audit using ISA. For public interest entities, the Higher Council should fully adopt the IAS/IFRS and the ISA, without any modification, and should prepare and disseminate official translation of these standards. It should also mandate the IFAC Code of Ethics for Professional Accountants for all registered public accountants.

- ***Prepare and disseminate guidelines on implementation of IAS and ISA.*** To facilitate proper implementation of IAS and ISA, it will be necessary to prepare and disseminate practical implementation guidelines. In collaboration with the professional accounting body in the country, the Higher Council should establish a mechanism to provide guidance on implementation of IAS and ISA in the Colombian environment. Any interpretations of IAS and ISA should be issued in consultation with the International Financial Reporting Committee (IFRIC) of IASB and the International Auditing and Assurance Standards Board (IAASB) of IFAC, respectively. All interpretations and other guidance should be made promptly available to accountants, auditors, students, teachers, regulators, and all other interested parties.
- ***Financial reporting by small and medium-sized enterprises (SMEs).*** The legislation should provide a simplified financial reporting framework more adapted to SMEs. The Higher Council should be authorized to set simplified financial reporting standards for SMEs in line with IAS. However, if the Higher Council deems it necessary to deviate from IAS, it should do so with a clear explanation of the reasons for the deviation.
- ***Lead national-level reform initiatives to facilitate implementation of IAS/IFRS and ISA.*** A long-term reform program will be required to successfully implement IAS/IFRS and ISA. The program will include significant improvements in accounting and auditing education; widespread training and knowledge enhancement of accountants, auditors, management personnel, academics, regulators, and various other government officials; and capacity building of various institutions.

43. **Establish a regulatory body responsible for enforcing accounting and auditing standards and a code of professional ethics.** The governance of the regulatory body should not be dominated by practicing accountants. This body should have sufficient full-time staff to carry out important enforcement-related activities. Through a formal arrangement with this regulatory body, the securities market regulator and the regulators of banks and other financial institutions should be able to use various information produced by this body—for example, financial reporting monitoring and compliance—as inputs to their own

total number of employees exceeding [a number to be decided in consultation with various stakeholders]; (b) total assets on the balance sheet exceeding [amount to be decided in consultation with various stakeholders]; and (c) total turnover exceeding [amount to be decided in consultation with various stakeholders].

decisionmaking concerning regulatory actions. The following three units are envisioned for inclusion in the organizational structure of the regulatory body:

- **Licensing.** The regulatory body would issue practicing licenses to candidates who have passed the qualification examinations and complied with the practical experience requirements for working as an independent auditor. The regulatory body would maintain a list of practicing license holders. It would specify the continuing professional education requirements—established in line with IFAC guidance—for practicing independent auditors and would enforce them as a condition for license renewal. At regular intervals, the regulatory body should evaluate practicing license holders’ compliance with continuing professional education and other factors related to professional performance, including compliance with auditing standards and code of ethics. On the basis of this evaluation, the regulatory body would decide whether to renew the practicing license.
- **Monitoring.** This unit would be responsible for analyzing and identifying noncompliance with the applicable accounting and financial reporting requirements. For this purpose, experts would review the financial statements of the public interest entities, including, as appropriate, the audit working papers and the enterprise’s books of account. If this monitoring process reveals material noncompliance with applicable accounting requirements, effective sanctions should be imposed on both preparers and auditors of financial statements. In conjunction with other regulatory bodies, appropriate arrangements should make enterprise management primarily responsible for infractions in the financial statements. The possibility of effective sanctions would create incentives for enterprise management to engage high-quality accountants and strong auditors to prepare and audit their financial statements. The monitoring should develop the capacity to conduct in-depth review of corporate financial statements to determine the extent of compliance with the standards and regulations—not only in appearance, but also in substance.
- **Auditors’ Review.** A team of reviewers would be responsible for reviewing the practices of independent auditors and audit firms that audit public interest entities. There should be an efficient and effective mechanism for taking disciplinary actions against auditors and audit firms found responsible for noncompliance with auditing standards and the code of professional ethics. Reviewers’ on-site inspection should focus on evaluating the audit firm’s quality assurance arrangements and examining its working papers for selected audit engagements. Moreover, there should be an arrangement to investigate auditors on the basis of complaints. The auditors’ review group should develop the capacity to efficiently conduct on-site inspections of audit firms. This group may not require a large number of full-time staff, but could borrow additional experts from outside sources.

44. **The new law should retain the present requirements on *revisor fiscal*, and should relieve independent auditors of public interest entities from the responsibility of carrying out activities that are the responsibility of enterprise management.** Independent auditors should not be asked to carry out additional internal control-related activities that are management's responsibilities and that could remain the responsibility of the *revisor fiscal*. There should be a clear distinction between an external independent audit and other compliance-related activities of the enterprise. These other compliance-related activities could continue to be carried out by either an internal department or individual or an external firm/individual that acts as the *revisor fiscal*. The external independent auditor of a public interest entity should not be allowed to perform the task of *revisor fiscal* of the same entity.

45. **Upgrade the procedure for licensing independent auditors.** To obtain a practicing license to qualify as an independent auditor, an individual should meet minimum requirements based on IFAC educational standards. The current system of issuing a license without a professional qualification examination and adequate practical experience should be changed to conform to international best practice. There should be a qualification examination based on a curriculum conforming to the IFAC standard on professional education, and there should be a practical experience requirement of at least three years with an authorized training provider under the supervision of an experienced independent auditor. To become an authorized training provider, a professional services firm should have sufficient capacity to allow the trainee auditor to gain exposure to the practical aspects of all applicable standards and codes. The regulatory body, which has responsibility for issuing the practicing license, should maintain a list of authorized practical training providers and update this list on the basis of periodic assessment of the capabilities of existing and potential training providers. The assessment should consider the number of partners and their experience, the nature of their clients, and other facilities available for providing high-quality practical training.

46. **Establish in law a professional organization of independent auditors.** This organization would help develop the financial statements audit profession, embody the functions recommended by IFAC, and protect the public interest by bolstering the quality of accounting, auditing, and financial reporting in Colombia. Its scope of work would include the oversight of professional qualification examinations and professional education and training, maintenance of high-quality professional practice, compliance with international best practices on professional ethics, and development of the technical competence of accountants and auditors. The existing professional associations should strengthen their capacity to contribute to the members' professional development and to accounting and financial reporting practices in the country.

47. **Provide training programs on practical aspects of IAS and ISA, including the ethical challenges faced by auditors.** The Higher Council on Accounting and the professional accounting organization should collaborate to organize training programs to enable practicing auditors and accountants to gain exposure to the practical application of the IAS, ISA, and IFAC-issued Code of Ethics for Professional Accountants. Practitioners should be encouraged to attend these training programs with a view to meeting requirements for continuing professional education.

48. **Retrain university accounting instructors and reform the accounting curriculum.** To ensure that universities maintain a minimum standard in accounting and auditing instruction, a well-coordinated initiative is necessary to develop the curriculum and train instructors. Universities curricula should be enhanced by including modern theories and practices of accounting and auditing, and practical application of IAS and ISA. Particular emphasis should be given to teaching business ethics as a separate subject in business schools and comparable institutions of higher education. One university in the country may be designated to organize activities in this regard. Under such an arrangement, experienced international instructors would teach the theory and practice of accounting and auditing (including practical application of international accounting and auditing standards, and business ethics) in training-the-trainers programs. Also, arrangements should be made to send selected university instructors to foreign universities for further education and retraining. In addition, efforts should be made to reform the accounting curriculum at universities, and to provide students easy access to appropriate academic literature, textbooks, and IAS and ISA in Spanish.