

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

## ACCOUNTING AND AUDITING

March 18, 2004

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### Overview

This report provides an assessment of accounting, financial reporting and auditing practices within the corporate sector in Ecuador, using International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA) as benchmarks and drawing on international experience and best practices in that field.

The adoption of Ecuadorian Accounting Standards (*Normas Ecuatorianas de Contabilidad*, or NEC) and Ecuadorian Auditing Standards (*Normas Ecuatorianas de Auditoría*, or NEA) in 1999-2000 represented a significant step forward for the country in improving the quality of its standards. Nonetheless, further efforts are needed to improve those standards which leave out a number of critical areas. In that regard, full adoption of IFRS and ISA by public-interest entities is widely viewed among country stakeholders as the best solution for Ecuador, and this report endorses the accounting profession's recent initiative for such adoption.

The enforcement of corporate financial reporting standards in Ecuador is the responsibility of the two self-regulated Superintendencies in their respective areas of purview: *Superintendencia de Compañías* for companies listed on the stock exchanges or which exceed a certain size; *Superintendencia de Bancos y Seguros* (SBS) for financial institutions, insurance companies and pension funds. The ROSC review found that the current level of enforcement must be substantially improved so that the needs of the users of financial information can be met.

Achieving quality financial information also depends on the effectiveness of the auditing process. In that respect, the lack of minimum academic and professional education requirements, as well as the absence of licensing and quality control mechanisms, raise serious concerns in the case of Ecuador. Accordingly, the ROSC Accounting & Auditing report recommends that an independent oversight body of the audit profession be established to ensure that auditors are qualified on the basis of strong academic and professional abilities, and that they comply with auditing standards and independence requirements.

Another important issue in Ecuador is the fact that audited financial statements are not normally published, which reduces the usefulness of the financial reporting and auditing process. This practice impedes transparency in the corporate sector.

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This report was prepared by a staff team from the World Bank on the basis of the findings from a diagnostic review carried out in Quito and Guayaquil from October to December 2003. The team comprised Henri Fortin (LCOAA) and M. Zubaidur Rahman (OPCFM). The review was conducted through a participatory process involving various stakeholders and led by the country authorities. The ROSC assessment was cleared for publication by the Ministry of Economy and Finance on January 19, 2005.

## ABBREVIATIONS AND ACRONYMS

AIC	Inter-American Accounting Association
CNV	National Securities Council
CCPP	College of Public Accountants of Pichincha
FCCPP	Federation of Colleges of Public Accountants of Peru
FNCE	National Federation of Accountants of Ecuador
GAAP	Generally Accepted Accounting Principles
GAAS	Generally Accepted Auditing Standards
GDP	Gross Domestic Product
IAASB	International Auditing and Assurance Standards Board
IADB	Inter-American Development Bank
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IES	International Education Standards for Professional Accountants
IFAC	International Federation of Accountants
IFRIC	International Financial Reporting Interpretation Committee
IFRS	International Financial Reporting Standards
IICE	Institute of Accounting Research of Ecuador
IMCP	Mexican Institute of Public Accountants
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
ISA	International Standards on Auditing
LGISF	General Law of the Institutions of the Financial System
LGS	General Law on Insurance
LMV	Securities Market Law
MEF	Ministry of Economy and Finance
MIF	Multilateral Investment Fund
NEA	Ecuadorian Auditing Standards
NEC	Ecuadorian Accounting Standards
OECD	Organization for Economic Co-operation and Development
PCAOB	U.S. Public Company Accounting Oversight Board
PIOB	Public Interest Oversight Board
ROSC	Reports on the Observance of Standards and Codes
SBS	Superintendency of Banks and Insurance
SIC	Standing Interpretation Committee
SME	Small and Medium Enterprises
SOE	State-Owned Enterprises
SRI	Internal Revenue Services

## EXECUTIVE SUMMARY

### Summary of Observations

1. The principal objective of this ROSC assessment is to assist the Government in strengthening private sector accounting and auditing practices and enhancing financial transparency in the financial and enterprise sectors. The primary development objective for this ROSC is to foster Ecuador's competitiveness and economic integration on regional and international levels, and to improve the investment climate. To the extent the recommendations address those issues, the groups who would benefit from these are: a) Ecuadorian enterprises, whose ability to attract investment and raise capital would be enhanced, b) the banking sector who need quality and reliable financial information from the corporate sector to conduct their business, c) the public sector from the point of view of its revenue generation, d) employees who have an important stake in the state of affairs of the company that employs them, and e) the profession itself who will benefit from building-up its institutional capacity and image before the public.

2. The main findings of this ROSC are:

- The public sector plays an essential role in setting and enforcing accounting and auditing standards in the private sector.
- The country's existing legal framework appears to provide an adequate basis for strengthening financial reporting practices in the near and medium terms, although reforms may be needed in the longer term.
- The quality of the financial statements is hampered by the fact that Ecuador's accounting standards have not been updated since 2000 and do not cover several important and often sensitive types of transactions.
- The impact of the financial reporting process is hindered by the fact that there is no obligation to publish financial statements. This is not favorable to the investment climate, to banking intermediation and ultimately for enterprises to obtain financing.
- There is little coordination between regulators of private sector financial reporting, especially with respect to the licensing and monitoring of auditors.
- Enforcement of accounting and auditing standards by the regulatory agencies is insufficient, particularly in the case of the Superintendency of Companies.
- The profession has adopted auditing and ethical standards of internationally acceptable quality, although they need some updating. Also, the SBS requires the use of ISA for the audits of financial institutions and insurance companies.
- However, current academic curricula do not provide sufficient assurance that the majority of would-be auditors have been adequately prepared to apply the standards. Further, licensing requirements are insufficient, there is an absence of quality control mechanisms, and sanctions are rarely imposed.
- Audit committees are uncommon among Ecuadorian companies as governance arrangements appear to be still in transition between family control and a larger stakeholder ownership.

## Recommendations

3. The recommendations arising from this ROSC Accounting and Auditing are for the most part enabled by the current legislative framework. They will be presented to the country stakeholders on occasion of a workshop in Quito where a Country Action Plan will be designed, to be developed under the supervision of the Ministry of Economy and Finance with the support of the World Bank and other international development partners.
4. Ecuadorian authorities should adopt IFRS and mandate their use for all public-interest entities in Ecuador as this would reflect the country's drive toward further economic integration on an international level, including within the Latin American region. This will require a decision by the Ministry of Economy and Finance, and would entail:
  - Establishing an independent accounting standard-setting body, at the initiative of the MEF with diverse private sector involvement and large representation of public interest. This would bring several benefits to the country as follows: a) stakeholders' commitment to the accounting standard-setting process; b) timeliness and due process in setting the standards; c) clarity and investors' confidence in applicable standards; and d) regional synergies, as ensuring maximum comparability among Latin American countries would require some degree of coordination with other Spanish-speaking countries.
  - Providing simplified accounting and financial reporting standards for SMEs in order to promote quality financial information among them and thereby facilitate their access to credit.
  - Harmonizing accounting principles for financial institutions and insurance companies with those used in the enterprise sectors.
5. In order to enhance transparency in the financial and enterprise sectors, financial statements should be made accessible to the public, and their frequency should be increased.
6. ISA should be mandated for all audits of financial statements in Ecuador and the accountants' code of ethics updated in line with the latest version of IFAC's Code of Ethics for Professional Accountants.
7. The MEF and the public institutions currently entrusted with regulating the profession of public accountants—i.e., the Superintendency of Companies, the SBS and the SRI—should establish an “Audit Oversight Board” governed by a majority of non-practitioners. It would deal with a) qualifying of auditors, b) enforcing auditing and ethical standards, c) fostering efforts by the profession to increase the quality of the audits, and d) enhance the image of the audit profession. This could be the same agency as the aforementioned independent accounting standard-setter. Stakeholders should decide on that based on country considerations in such a way that effectively supports the oversight objectives pursued by the ROSC recommendations.
8. In order for practitioners to have sufficient knowledge and competence in the field of accounting and auditing, academic curricula should be harmonized and strengthened, and professional education and training should be required.
9. Governance mechanisms within public-interest entities should be established so as to ensure the transparency of the audit process, including the appointment and remuneration of independent auditors.

Implementing the above recommendations will require Technical Assistance mainly to a) design the processes under which the two new self-regulatory bodies would operate and the existing regulators would conduct enforcement actions, b) drafting the corresponding regulation and c) handling related human resources issues. Substantial training will also be needed to supplement the regulators' existing capacity and to establish the standard-setting and oversight bodies. The content, cost and funding of the Technical Assistance needed—which is expected to be relatively modest—as well as the training efforts and the recurring budget of the two institutions, will be dealt with in the Country Action Plan.

## I. BACKGROUND

1. The review of accounting and auditing practices in Ecuador is 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 focuses on the strengths and weaknesses of the accounting and auditing environment that influence the quality of financial reporting in the private and state-owned financial and enterprise sectors. International Financial Reporting Standards (IFRS)<sup>1</sup> and International Standards on Auditing (ISA) were used as benchmarks for the assessment, and involved a study of both mandatory requirements and actual practices.

2. Ecuador has a population of 13 million and a GDP per capita of approximately \$2,000. Its history has been characterized by instability, both political and economic, and by a difficulty establishing an adequate institutional framework to ensure sustained economic development. In the institutional and political arena, there have been 19 constitutions since the country's independence in 1830, and the recent years saw many changes in the head of the State. Agriculture is still the primary activity, representing 12% of GDP, thanks to a topography and climate favorable to a large variety of crops and to fishery activities. The oil sector is also a prime source of exports for Ecuador. Such strong dependence on those sectors exposed the country to the negative effects of both El Niño and the fall in oil price in the late 1990's. Small and medium enterprises play an important role in Ecuador's economy, accounting for more than 70% of employment in Ecuador. Certain key economic sectors such as telecommunications and electricity generation and distribution are state-controlled. Ecuador's economic activity is highly concentrated in the two large metropolitan areas of Quito and Guayaquil, which are also prominent political poles. The latter enjoys a geographic advantage as the country's main port, which favors its export-oriented industrial and trading activities. A number of organizations and administrative structures, both public and private, are duplicated between the two areas, which can weaken the overall institutional framework.

3. **After the severe economic crisis of the late 1990s, Ecuador has initiated several financial and fiscal reforms toward sustained economic growth.** In March of 2000, in the wake of an economic recession triggered by a severe banking and currency crisis, Ecuador adopted the US dollar as its national currency. Since then, and after the re-negotiation of the national debt, the country's economic situation significantly improved, with a growth in GDP per capita of 3.8% on average between 2000 and 2002. The new administration, which came to power in January 2003, adopted an economic reform program and received the support of the IMF with which a 13-month stand-by agreement was signed.

4. **The financial system in Ecuador is dominated by large domestic banks, with capital markets still paying a relatively limited role.** At present, capital markets play a relatively limited role in the country's economy, and trading on the stock exchanges of Quito and Guayaquil mostly involves fixed-income bonds issued by the state of Ecuador, in a context of high liquidity. As at December 2003, 35 companies were listed on both stock exchanges<sup>2</sup> and, among them, the top five represent more than 80% of the total market capitalization. The banking sector is made of 22 banks, including three foreign-owned and two state-controlled and underwent a heavy restructuring in the recent years. It is still relatively less developed than in

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<sup>1</sup> IFRS correspond to the pronouncements issued by the International Accounting Standards Board (IASB) and International Accounting Standards (IAS) issued by its predecessor, the International Accounting Standards Committee (IASC), as well as related official interpretations.

<sup>2</sup> Among the largest 50 domestic companies, 25 are publicly traded.

other Latin American economies, with total asset of US\$6 billion at the end of 2003. There are 32 insurance companies active in Ecuador, which earned premiums of US\$400 million in 2002.

5. **The Government has set out several key development objectives for the medium term, including the reduction of poverty and sustained growth of the GDP, at 5% per year.** To achieve such level of economic growth, the Government's priorities are fiscal consolidation, increased competitiveness in the private sector, reforming the labor market to provide more flexibility, and strengthening the country's financial sector.

6. **Ecuador's development strategy can benefit from improved private sector financial reporting practices.**

- In view of its fiscal consolidation objective, the government's reform package provides for an increase in the State's revenues. To achieve that goal, a key condition will be to ensure the reliability of the accounting information, which serves as the basis to levy taxes on corporations' earnings.
- In the financial sector, the government seeks to reinforce banking supervision and also contemplates the privatization of the main state-owned commercial bank. Achieving those objectives will entail robust financial reporting practices, as these have proven to be critical in the banking sector.
- In the corporate sector, the *Fondo de Solidaridad*, a public entity overseeing Ecuador's state-owned enterprises (SOEs), has begun awarding concession contracts to international investors to operate those state-controlled activities. This project is all the more strategic for Ecuador as these activities are currently among the country's highest tax contributors. Considering such strategic importance and the financial complexity of concession arrangements, financial reporting will provide a useful tool for the government to monitor those activities in the future. Also, from the investor's standpoint, access to transparent and reliable financial information is key to the investment process.
- Also critical is Ecuador's need to boost its capital markets, so as to enhance corporate entities' access to long-term financing, and thereby foster private sector growth. In that perspective, the two national stock exchanges are seeking to increase the number of listed companies and the volume of trading. However, developing the stock exchanges will require a high level of confidence on the part of investors, especially with respect to the quality and reliability of the financial statements as those are an essential tool for monitoring their investments.
- More generally, improving private sector financial reporting standards and practices represents a parallel effort to the public sector's move toward greater transparency and accountability.

## **II. INSTITUTIONAL FRAMEWORK FOR PRIVATE SECTOR ACCOUNTING AND AUDITING**

### **A. Statutory Framework**

7. **Accounting, financial reporting and auditing requirements for corporate entities in Ecuador are prescribed under the Corporations Law of 1999.** The law requires that the Directors of the company prepare, within three months after the fiscal year's closing date, a

balance sheet and a profit and loss statement to be submitted to the shareholders' general meeting for approval. Moreover, the balance sheet and the profit and loss statement together with their footnotes shall "give a true and fair view of the financial position of the company at the end of the fiscal year and of the economic result of operations for said fiscal year, in accordance with GAAP". Furthermore, the companies' accounting policies and books of accounts must conform with the standards issued by the Superintendency of Companies (*Superintendencia de Compañías*), an autonomous, public institution recognized by Ecuador's constitution.

8. **The Superintendency of Companies has officially adopted the Ecuadorian Accounting Standards issued in 1999 and 2000.** Through Resolution no. 99.14.3.3.007 of August 1999, the Superintendency of Companies adopted the first series of 15 Ecuadorian Accounting Standards (*Normas Ecuatorianas de Contabilidad* or NEC) issued that same year by the Ecuadorian National Federation of Accountants (*Federación Nacional de Contadores del Ecuador* or FNCE, a self-regulated professional organization), on the basis of IAS. Subsequently, NEC 16 to 27 issued by the FNCE in April 2000 were also adopted by the Superintendency through Resolution no. 02.Q.ICI.003 of March 2002. Such endorsement has been a positive move toward increasing the quality of the financial information in Ecuador's corporate sector. However, the Superintendency does not allow the use of IFRS for statutory purposes, which would allow corporations, on a voluntary basis, to better satisfy the needs of shareholders and other financial statements users.

9. **The obligation to prepare consolidated financial statements has not yet been enforced by the Superintendency of Companies.** NEC 19, *Consolidation of Financial Statements and Accounting for Investment in Subsidiaries* was officially adopted in March 2002, with mandatory application for fiscal years beginning on January 1<sup>st</sup>, 2002. However, the Superintendency of Companies subsequently decided to postpone the application of NEC 19 by one year.<sup>3</sup> As a consequence, to this date, only banks and insurance companies have issued consolidated financial statements in Ecuador. This represents a potentially serious weakness as non-consolidated information provide an incomplete if not distorted presentation of companies' financial position and economic performance.

10. **The tax authorities are empowered to regulate accounting and auditing activities in Ecuador.** Under the tax law (*Ley de Regimen Tributaria Interna*), companies with common stock are required to keep books of accounts prepared in accordance with NEC<sup>4</sup>, or with IAS in areas which are not covered by NEC. Corporate income tax is computed on the basis of taxable profits which are derived from the books of accounts after certain adjustments to comply with specific recognition or measurement rules mandated by the tax authority.

11. **Financial reporting requirements for listed companies are set out in the Securities Market Law.** Under the Securities Market Law (*Ley de Mercado de Valores* or LMV), the National Securities Council (*Consejo Nacional de Valores* or CNV), is the official, public body regulating the securities market in the country. As such, it is responsible for "issuing the chart of accounts and accounting standards for market registrants". Moreover, the LMV regulates auditing activities, including independence, incompatibilities, confidentiality, communication of findings, etc., and mandates the change of an audit firm's signing partner after five years. Enforcement of the LMV and CNV resolutions is delegated to the Superintendency of Companies, which may conduct inspections of and impose sanctions upon auditors, up to the removal of license in case of

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<sup>3</sup> Superintendency of Companies Resolution 03.Q.ID.003 issued on March 11, 2003

<sup>4</sup> NECs currently in force were approved by the SRI through Resolutions no. 140 of August 1999 (NEC 1-15) and 1072 of September 2002 (NEC 18-27).



non-compliance with generally accepted auditing standards or accounting principles. Listed companies must provide their audited annual financial statements to the Superintendency of Companies. There are no requirements for listed companies to publish half-year or quarterly financial statements.

12. **Banks, other financial institutions and insurance companies are subject to separate financial reporting regulation.** Under the General Law of the Financial System Institutions (*Ley General de Instituciones del Sistema Financiero* or LGISF) of 2001, banks, investment funds and savings and loans institutions are required to prepare their financial statements in accordance with the accounting norms issued by the Superintendency of Banks and Insurance (*Superintendencia de Bancos y Seguros* or SBS, one of the state's supervisory entities provided by the Constitution). These include submitting to the SBS monthly, quarterly and year-end financial reporting under the specific format and accounting policies of SBS's Unified Chart of Accounts (*Cátalogo Único de Cuentas*)<sup>5</sup>. Annual financial statements must contain accompanying footnotes under a SBS-prescribed format, and an opinion from an independent auditor. Both consolidated and "standalone" financial statements are mandatory and must be audited. SBS regulation also provides that auditors must apply ISA and prohibits them from rendering any non-audit services to audit clients other than recruitment services. Insurance companies also follow specific financial reporting requirements set out by the SBS pursuant to the General Law on Insurance (*Ley General de Seguros* or LGS), including a chart of accounts and the rules on auditors provided by Resolution JB-2003-574. There is also a requirement by the SBS to appoint an internal auditor in banks and insurance companies.

13. **In addition to listed companies, all Ecuadorian corporate entities with assets exceeding US\$1 million<sup>6</sup> must subject their statutory financial statements to an audit in accordance with NEA.** The Corporations Law requires that independent auditor's report on year-end financial statements be submitted to the shareholders at least eight days prior to the general meeting convened to approve the financial statements. The statutory audit obligation currently applies to an estimated 1,200 companies in Ecuador. Under the Law, auditors are granted access to all information and documentation they may deem necessary to fulfill their assignment. Additional requirements regarding statutory audit have been set by the Superintendency of Companies in Resolution no. 02.Q.ICI.008 of April 2002, dealing with matters such as the form and content of the financial statements and the auditor's report, the appointment of the auditor, etc. Resolution 02.Q.ICI.008 also mandates that audits be conducted in accordance with NEA. The fact that the audit requirement for non listed companies is exclusively based on a single criterion raises a concern, as it may lead to omit enterprises of significant size in terms of number of employees or revenues.

14. **Annual statutory financial statements of all Ecuadorian corporate entities must be filed with the Superintendency of Companies.** Under the Corporations Law, all companies incorporated in Ecuador are subject to the supervision of the Superintendency of Companies and as such they must provide the Superintendency with their fiscal year-end balance sheet and profit and loss statement no later than April 30 of the following year. In the case of companies whose financial statements are required to be audited, the auditors must provide the Superintendency with a copy of their report no later than eight days after its issuance.

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<sup>5</sup> Resolution JB-2003-574.

<sup>6</sup> This threshold has been set by the Superintendency of Companies for 2003 (Resolution no. 02.Q.ICI.0012, July 2002) pursuant to Corporations Law's Article 318. Up until 2001, the limit was set at US\$500,000, then was raised to US\$ 2 million for 2002. There is the same requirement for local branches of foreign companies when such branches have assets in excess of US\$100,000.

15. **The Corporations Law does not provide for any governance arrangement within the company to monitor the independent audit process on behalf of shareholders.** Under the Law, the auditors are appointed by, and must report to, the shareholders' general meeting. However, since neither the Law nor the Superintendency of Companies' regulation require companies to establish audit committees<sup>7</sup> or similar bodies in charge of governance, the process of appointing, monitoring and renewing the external auditors' mandate is highly informal. As a matter of example, companies are not required to invite auditors to attend the shareholders' general meeting to answer questions. Management and shareholders representing at least 10% of outstanding stock may call upon the auditors to clarify any matter related with the fiscal year-end financial statements subject to the audit.

16. **The Superintendency of Companies and the SBS each keep a registry of accountants authorized to perform statutory audits in their respective areas of supervision.** For entities subject to an audit under the Corporations Law, auditors must be selected from the list of authorized auditors published by the Superintendency of Companies on its website. Both individual accountants and accounting firms can be included on the registry. According to the most recent list updated in May 2003, there were over 300 auditors qualified by the Superintendency of Companies<sup>8</sup>. For banks and insurance companies, they also have the obligation to select their auditors from a registry established by the SBS.

17. **The Superintendency of Companies does not require any professional affiliation or public accountant qualification for registration as statutory auditor.** Under Superintendency of Companies Resolution no. 02.Q.ICI.007<sup>9</sup> of April 2002, in order for auditors to be included in the Superintendency of Companies' registry, they must demonstrate at least three years of professional experience in the field of auditing and provide their resume. In the case of accounting firms, they must provide evidence that their directors and staff have a degree in accounting or in economy. It is understood that a significant number of currently authorized auditors have an educational background in the field of economics, which is not in line with international best practices and raises serious concerns as to the competence of these individuals to perform audits of financial statements. Qualification by the Superintendency is granted for periods of five years.

18. **SBS has set detailed requirements with respect to the appointment of auditors.** Firstly, in order to qualify as auditors of banks or insurance companies, accountants must have a university degree in accounting, be affiliated with a college of accountants (*colegios de contadores*) and provide evidence of their experience and competence in audits of financial institutions. Secondly, individuals are only authorized to perform audits in credit unions (*cooperativas*) and financial services companies. As a result of the application of those requirements, the number of auditors licensed by the SBS is relatively limited.<sup>10</sup> Auditors are appointed for renewable periods of one year, up to a maximum of five years after which they

<sup>7</sup> The situation is different for banks which, under Resolution JB-2003-586 of October 2003, will be required from 2004 onward to establish a *comité de auditoría* which will act as an advisory body assisting the bank's management in facilitating the audit process and monitoring internal controls.

<sup>8</sup> The list of qualified auditors is available on the websites of each Superintendency, respectively at [http://www.supercias.gov.ec/auditores\\_calif.htm](http://www.supercias.gov.ec/auditores_calif.htm) and [http://www.superban.gov.ec/downloads/main/auditoras\\_externas-5\\_nov\\_03.xls](http://www.superban.gov.ec/downloads/main/auditoras_externas-5_nov_03.xls).

<sup>9</sup> Resolutions of the Superintendency of Companies regarding statutory audits are available on SRI's website at [http://www.sri.gov.ec/pages/guia\\_contribuyente/auditores\\_externos.html](http://www.sri.gov.ec/pages/guia_contribuyente/auditores_externos.html).

<sup>10</sup> Currently there are respectively 10 and 15 firms authorized by SBS to carry out audits of private banks and for insurance companies. The number of licensed individuals is less than 10.

must be replaced. In the case of a financial group, the subsidiaries must have the same auditor of the parent company, or by one that is affiliated with it. Finally, auditors are prohibited to render any other service to the financial institution in such a way that might appear as a breach of independence<sup>11</sup>.

19. **Under the tax law, auditors are also required to issue an opinion on compliance with tax regulation.** All entities required to present audited financial statements under either Superintendency of Companies or SBS regulation must also file a tax-compliance report (*informe de cumplimiento tributario*) with the Internal Revenue Services (*Servicio de Rentas Internas* or SRI), no later than May 31<sup>st</sup> of the following year. The reliability of the financial statements of entities subject to an audit is all the more critical to the SRI as these contribute over 80% of the total country's tax revenue. Through resolution 1071 of December 2002, the SRI has set forth detailed guidance for the auditor's reports on tax compliance, including standards forms and reports. Although this tax-purpose obligation is theoretically largely redundant with the statutory audit requirement under the Corporations Law, it is clearly indicative of the fact that the tax authority does not place strong reliance on the statutory audit process for its own purposes<sup>12</sup>.

20. **Ecuadorian law requires that shareholders appoint a *comisario*.** As per requirement of the Corporations Law, a *comisario* must be appointed at the annual general meeting of shareholders for a one-year period to supervise the management of the company. This individual's responsibilities explicitly include "reviewing the balance sheet and profit and loss statement and present a duly supported report to the shareholders' general meeting". The *comisario* is also required to report to the Superintendency of Companies any unusual matter identified as part of his assignment. The *comisario* has broad power to carry out its duties, including the right to attend board meetings—with no voting right, to call a meeting of shareholders, and to have full access to, and examination of, company information. No professional title of any kind is required for this individual. This person can be dismissed at anytime by the shareholders' meeting and is personally liable for failures to fulfill its duties toward the company. There are no known cases of lawsuits against *comisarios*. As for banks, other financial institutions and insurance companies, the SBS requires the *comisario's* report to be issued by external auditors. The role of the *comisario*, who is a traditional figure in Latin American corporate law, is largely redundant with that of the auditors and is not an adequate substitute for a governance body in line with more recent improvements in corporate practices on an international level.

21. **There is no obligation to publish statutory audited financial statements, nor are they publicly accessible on an official website.** There is no legal requirement for publication of company financial statements in Ecuador. In the case of listed companies, the only publicly accessible information is a summary of financial indicators including equity, net income, total assets, etc. published on the Quito Stock Exchange's website<sup>13</sup>. Regarding non-listed companies whose financial statements are required to be audited, no information is available on the Superintendency of Companies or the SRI websites. As for banks and insurance companies, the balance sheet, income statement and statement of cash flows are accessible on line under the SBS chart of accounts format on the SBS's website. Finally, it should be noted that audited financial statements are not normally posted by the companies on their websites. Overall, this situation seriously reduces the usefulness of the financial reporting and auditing process. It is an

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<sup>11</sup> Those provisions are set-out in Resolution JB-2003-574 of September 2003.

<sup>12</sup> Other countries (including Mexico) mandate tax-purpose audits but, contrary to Ecuador, this obligation often apply to entities which are not subject to a statutory audit under the corporate law.

<sup>13</sup> Further details can be obtained at [http://www.ccbvq.com/zhtmls/p\\_ruedanet/p\\_Balances.htm](http://www.ccbvq.com/zhtmls/p_ruedanet/p_Balances.htm).

impediment to transparency in the enterprise and financial sectors and can therefore have detrimental effects on the country's investment climate.

## B. The Profession

22. **The accounting profession in Ecuador is regulated by a specific act.** The Law of Accountants (*Ley de Contadores*<sup>14</sup>) passed by Congress in 1966 sets out the conditions for accessing the profession, defines the fields of activity which require being a professional accountant, and establishes the institutional bodies through which the profession is organized as well as other aspects of the profession's organization.

23. **The Law of Accountants recognizes two categories of members: the *contador público* and the *contador-bachiller***<sup>15</sup>. As is traditional in Latin America, the Law grants membership to those individuals who have obtained a degree in accounting acknowledged by the Ministry of Education. In Ecuador, the titles of *contador público* and *contador-bachiller* respectively correspond to university and secondary education degrees. Although no official statistics are available as to the number of professional accountants in the country, a majority of them are believed to be *contadores-bachilleres*. Both are entitled to perform bookkeeping and other related services, but only a *contador público* can perform audits<sup>16</sup> of financial statements.

24. **The FNCE is a self-regulated, private institution officially representing the accounting profession in Ecuador.** Established in 1945, the FNCE is recognized by the Law of Accountants as the official representative institution at a national level. It comprises the National Congress of Accountants, the Executive Board (*Directorio Central*) and the 22 territorial colleges (*colegios de contadores*). The FNCE is not actively engaged in international organizations other than the Inter-American Accounting Association (AIC), a regional federation whose main activity consists of organizing professional seminars<sup>17</sup>. According to the FNCE, it has around 75,000 registered members of which 32,000 are *contadores públicos*. The number of active accounting practitioners is believed to be in the region of 14,000.

25. **Affiliation to either a college of accountants**<sup>18</sup> **or to the FNCE is not required to perform accounting activities in Ecuador.** Initially, the Law on Accountants provided that, in order to practice as accountants, professionals had to be registered on the National Registry of Accountants of Ecuador and to obtain a license from the FNCE. The Law also prohibited any public or private entity to hire individuals or firms whose owners did not fulfill the aforementioned conditions. However, in July 1997, those provisions of the Law were struck down by the Constitutional Tribunal following a lawsuit filed by certain groups outside the accountancy community. Presently a bill is being discussed at the National Congress of Ecuador<sup>19</sup> which

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<sup>14</sup> *Decreto Supremo* no. 1549.

<sup>15</sup> The full title is *Contador-Bachiller en Ciencias de Comercio y Administración*.

<sup>16</sup> The Law on Accountants mentions "practicing audits" among the list of activities authorized for a *contador público*, but no definition is provided, nor are "financial statements" mentioned.

<sup>17</sup> Ecuador does not appear on the list of members published on IFAC's website.

<sup>18</sup> The colleges of accountants are autonomous organizations in each province, which develop social and training activities for their members with the objective of fostering the image of the profession. The main colleges are those of Pichincha (province of Quito) and Guayas (province of Guayaquil), which account for respectively 40-50% and one-third of total FNCE membership.

<sup>19</sup> The proposed *Ley del Ejercicio Profesional de los Contadores* was first debated on November 20, 2002 before the Congress and would replace the existing Law of Accountants. In addition to requiring

would reinstate the requirement of professional affiliation and registration among other conditions to exercise the profession of accountant. Although compulsory professional affiliation is a common practice in many countries, it is not sufficient *per se* to ensure that members of the professional organization would comply with standards of quality and ethics. Without proper mechanisms within the FNCE to ensure compliance, the mandatory affiliation is not likely to bring any significant improvement in that regard.

26. **The code of ethics developed by the FNCE provides the fundamental principles of professional ethics for accountants as well as some guidelines to apply those principles.** In 1991, pursuant to the Law of Accountants, the FNCE, jointly with the Institute of Accounting Research of Ecuador (*Instituto de Investigaciones Contables del Ecuador* or IICE), issued an Accountant's Code of Ethics. The code is a 22-page document made of six general postulates, similar to those set-out in IFAC's Code of Ethics for Professional Accountants, and seven ethical standards including implementation guidelines. The general postulates stress the "responsibilities and obligations toward those who rely on the (accountant's) work", although they fall short to promote the notion of public interest as a "distinguishing mark of the profession". The ethical standards deal with Advertising and Solicitation (No. 1); Professional competence (No. 2); Integrity, Objectivity and Independence (No. 3); Confidentiality (No. 4); Ethics in International Practice (No. 5); Conditions to accept a client to which services are provided by another accountant (No. 6); and Conditions to replace an existing independent accountant (No. 7).<sup>20</sup>

27. **The FNCE Code of Ethics is not actively enforced.** Under the Law of Accountants, within the provincial colleges of accountants, a Disciplinary Board (*Tribunal de Honor*) is empowered with investigating and ruling on cases of non-compliance with Accountant's Code of Ethics. However, the sanctions which the Board can impose are limited to admonition or fine for symbolic amounts. Also, there are no procedures in place to ensure compliance with the Code. Such absence of systematic enforcement and effective sanction mechanisms raises strong doubts as to the effective compliance with the Code.

28. **Auditors' accountability vis-à-vis the stakeholders appears limited.** The Law on Accountants does not require practitioners to take out professional liability insurance, and only the largest international firms appear to have subscribed such insurance. Moreover, Ecuador's criminal code does not provide a basis for sanctions against errant auditors, nor does the civil code facilitate lawsuits against them. Indeed, there are no known cases of civil lawsuits involving auditors in Ecuador.

29. **The four largest international audit firms dominate the market for listed companies and financial institutions.** Almost all companies listed on the stock exchanges are audited by one of the Big-4 firms. Regarding banks and insurance companies, as previously noted, the SBS restricts access to the registry of auditors to a limited number of audit firms and in reality most of those entities are also audited by the Big-4 firms. As for companies required to submit their financial statements to an audit pursuant to resolution no. 02.Q.ICI.0012 of the Superintendency of Companies, there is no information available regarding the market share of the different firms qualified by the Superintendency.

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affiliation, the proposed bill would phase out the contadores-bachilleres over a six-year transition period.

<sup>20</sup> The text of the code of ethics is available on the college of Pichincha's website at [http://www.ccpp.org.ec/CODIGO\\_DE\\_ETICA\\_DEL\\_CONTADOR\\_ECUATORIANO.doc](http://www.ccpp.org.ec/CODIGO_DE_ETICA_DEL_CONTADOR_ECUATORIANO.doc)

### C. Professional Education and Training

30. **There are no minimum requirements regarding the content of academic curricula leading to the accounting profession.** Ecuadorian universities enjoy a high level of autonomy in defining their academic curricula. Accordingly, the title of *contador público* does not necessarily reflect a homogeneous level of quality. The Big 4 audit firms recruit mostly graduates from a few leading universities in Quito or Guayaquil which have developed accounting and auditing curricula in line with IFAC's International Education Standards or Guidelines, and include an adequate blend of technical, legal and business knowledge and emphasizes ethical issues.

31. **There is neither a professional examination nor a practical experience requirement for registering as a professional accountant in Ecuador.** Under current legislation, the only requirement to become a licensed accountant is having obtained a degree in accounting from any Ecuadorian university (for a *contador público*) or secondary education institution (for a *contador-bachiller*). This contravenes the principles that would-be practitioners must demonstrate adequate technical knowledge and professional skills before being awarded a professional license<sup>21</sup>.

32. **Registration as a professional accountant does not entail any continuing education requirement.** The professional colleges offer, on a voluntary and often complimentary basis, courses for registered accountants, mainly on tax law. Auditors employed by practices affiliated to international firms participate in training sessions organized by those firms.

### D. Setting Accounting and Auditing Standards

33. **There is no legally established accounting standard-setting body in Ecuador.** Under the various applicable acts, the Superintendency of Companies, the SBS and the SRI are empowered to set their own accounting rules.

34. **The IICE has been established within the profession as the entity dedicated to developing accounting and auditing standards in Ecuador.** Established by the National Congress of Accountants in 1964, the IICE is a not-for-profit organization recognized by the Ministry of Education and dedicated to the development of technical research in the field of accountancy. With only three permanent staff, the IICE has limited resources and mainly relies on the personal contribution of members in its various committees, most of who are active practitioners working at the leading audit firms.

35. **Ecuadorian Accounting Standards (NEC) and Ecuadorian Auditing Standards (NEA) were developed in 1999 and 2000 as a result of a collective undertaking led by the prominent accounting firms in the country.** Reflecting on the difficulties caused by the lack of national accounting principles in Ecuador, a group of seven audit firms established in Ecuador, including the affiliates of the five leading international networks at the time, carried-out the development of NEC and NEA. This process was conducted within the framework of the profession's representative bodies in Ecuador<sup>22</sup>. The standards were developed on the basis of respectively IAS and ISA, through the translation into Spanish of the original text in English.

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<sup>21</sup> In the field of accounting and auditing, IFAC has issued an educational standard (IES 6 *Assessment of Professional Capabilities and Competence*, released in October 2003) which sets forth this type of requirements.

<sup>22</sup> The body which officially developed the standards is the IICE's Technical and Pronouncements Committee (*Comité Técnico y de Pronunciamentos*).

Because this process was handled without any type of international cooperation, the text of the standards differ from other existing Spanish translations of IAS or ISA<sup>23</sup>.

36. **There is no continuing process of updating accounting or auditing standards in Ecuador.** Due to their lack of resources, the FNCE and the IICE have not established permanent mechanisms to amend existing standards or issue new ones. In fact, after the second series of NEC were promulgated in 2000, the IICE's Technical and Pronouncements Committee did not undertake any significant activity, and the standards have remained completely unchanged in the last three years.

#### **E. Enforcement of Accounting and Auditing Standards**

37. **Enforcement by the Superintendency of Companies is mostly formal and reactive.** Under Resolution no. 02.Q.ICL.008 of April 2002, the Superintendency of Companies may request at any time communication of the auditor's working papers. This includes all related evidential documentation, as well as any explanation or clarification on compliance with their responsibilities. However, the Superintendency which, under Corporations Law, is entrusted with the enforcement of all the Law's provisions applicable to corporate entities in the country, dedicates most of its resources to formal requirements such as the filing of financial statements, compliance with rules relating to business combinations, etc. Effective and in-depth verification of compliance with financial reporting requirements is not performed a systematic and preventive basis. This situation provides leeway for non-compliance with applicable standards as illustrated in paragraph 44 hereafter.

38. **The SBS enforces regulatory accounting and financial reporting requirements standards applicable to banks and insurance companies.** Monitoring and supervision functions for banks and other financial institutions, are assigned within the SBS to the recently formed National Risk Department (*Dirección Nacional de Riesgos*), with the operational support of the National Intendancy of Banks (*Intendencia Nacional de Bancos*). The National Risk Department has a large staff of relatively experienced personnel with educational background in economics, accounting or business administration, dedicated to on-site inspections and off-site analyses. A procedures manual for on-site supervision, developed by the SBS with the support of a large accounting firm, has been effectively applied since 2003. Those procedures include reviewing the external and internal auditors report, performing risk analyses and ensuring compliance with applicable prudential regulation and adequate risk management practices. The main findings of the inspection are documented in a report submitted to the financial institution for comments and proposed actions. In the field of insurance, enforcement mainly consists in automatically processing the information contained in the companies' financial statements.

39. **There are no independent enforcement mechanisms of auditing standards within the profession.** The FNCE or the provincial colleges of accountants have not put any mechanism in place to enforce the quality control requirements set out in NEA 3 *Quality Control for Audit Work* (equivalent of ISA 220). Compliance with quality standards is only ensured through the voluntary internal procedures of the firms, mainly the international ones.

40. **Regulatory bodies are empowered to impose administrative sanctions on errant auditors although few have been imposed in the recent years.** The main sanction that the

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<sup>23</sup> Such as those issued by the Mexican Institute of Public Accountants (IMCP) or by the Federation of Colleges of Public Accountants of Peru (FCCPP).

Superintendency of Companies or the SBS can impose on auditors is removing them from the registry. In the case of the Superintendency of Companies, there are no known cases of such sanctions in the last five years. As for the SBS, the banking regulator has suspended two auditors for faulty audits in the recent years.<sup>24</sup>

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

41. **Although based on IAS, NEC are significantly less complete as it has left out several sensitive areas.** The NEC were adopted in two waves, as follows: the *Framework for the Preparation and Presentation of Financial Statements* and NEC 1 to 15 in August 1999, and NEC 16 to 27 in April 2000. The rationale for such gradual approach was that it allowed enough time for the translation of the IAS statements and for the dissemination of the newly adopted NEC statements among the profession and other stakeholders. Also, the first 15 standards adopted were viewed as easier to implement in the country, while it was considered that more complex issues such as consolidation, impairment of assets or intangible assets should be dealt with later. However, the process of adopting IAS has not been completed and no new NEC pronouncements have been adopted since 2000. Also, during the same period, several new pronouncements were adopted by the IASB. As a result, the NEC do not cover the following areas:

- Agriculture (IAS 41),
- Employee benefits (IAS 19)<sup>25</sup>,
- Financial instruments (IAS 32 and 39),
- Income taxes (IAS 12),
- Interim financial statements (IAS 34),
- Investment property (IAS 40),
- Joint-Ventures (IAS 31), and
- Leases (IAS 17).

Additionally, it should be noted that interpretations issued by the Standing Interpretations Committee (SIC) and its successor International Financial Reporting Interpretation Committee (IFRIC), which are integral components of IFRS, have not been adopted in Ecuador. This leaves preparers of financial statements in the country without the needed guidance for applying NEC in specific circumstances, and may lead to inconsistent application of the standards. Finally, a number of the IAS statements on the basis of which NEC were developed in 1999 and 2000 have been amended since then, while NEC have remained unchanged as noted before.

42. **The absence of accounting standards in sensitive areas poses a serious threat to the quality of the financial information in the corporate sector.** Under IAS 1 *Presentation of Financial Statements*, there is a fundamental requirement that all standards within IFRS be fully complied with, the main reason being that applying only part of the standards may produce incomplete, misleading information. In the case of Ecuador, the absence of standards dealing with potentially sensitive but frequent transactions, such as financial instruments, income taxes or leases, can lead to situations where the information produced does not achieve the financial statements' objective to provide a fair presentation.

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<sup>24</sup> Further information is directly accessible on SBS's website.

<sup>25</sup> Also, IAS 26 *Accounting and Reporting by Retirement Benefit Plans* has not been translated into NEC.



43. **The accounting principles applicable to general-purpose financial statements of banks or insurance companies differ significantly with IFRS.** Under the LGISF and the LGS respectively, banks and insurance companies apply the mandatory chart of accounts and accounting principles promulgated or accepted by the SBS. These comprise a set of resolutions issued by SBS – dealing mainly with loan-loss provisioning, valuation of property, consolidation or combination of financial statements, equity investments, etc. – and IFRS insofar as they do not contradict SBS-issued accounting rules. The ROSC review noted that, as of December 31, 2002, the general-purpose financial statements of banks in Ecuador included a specific explanatory note summarizing the main differences between accounting principles applied under the rules dictated by SBS and IFRS. Based on that information and the review of published SBS accounting rules, inconsistencies with IFRS exist in the following areas:

- *Loan-loss provisioning* – Under SBS rules, banks must record a minimum amount of impairment losses on past-due loans, using fixed provision rates depending on the type of loan (consumer, commercial, mortgage, etc.)<sup>26</sup>. This approach, which is often followed by banking supervisors for regulatory financial reporting, is not consistent with IFRS (IAS 39 specifies that impairment losses should be calculated on the basis of expected future cash flows).
- *Investment in government bonds acquired in relations with the acquisition of assets and liabilities of distressed entities* – Banks that have acquired such bonds are not required to write them down on the basis of fair market value. IAS 39 would not allow such treatment. Also, under SBS rules, banks may record losses on such investments directly through a reduction of equity, which is not permitted under IAS 39.
- *Valuation of Property* – Property acquired as payment of secured loans must be depreciated after 120 days from the date of acquisition. Also, banks are obliged to revalue their property every five years, and cannot make such revaluation in the meantime. IAS 40 offers a different treatment for the measurement of this type of asset, including a cost or a fair value model.
- *Goodwill amortization* – SBS rules are more conservative than IAS 22 as they limit the amortization period to 10 years.
- *Group accounting policies* – Financial statements of subsidiaries included in the consolidation must follow the accounting principles prevailing in their respective country, which contradicts the requirement of IAS 27, *Consolidated Financial Statements and Accounting for Investment in Subsidiaries* that “consolidated financial statements should be prepared using uniform accounting policies for like transactions”.
- *Taxation* – Under SBS rules, there is no obligation to recognize deferred tax on all temporary differences.
- *Presentation of financial statements* – There is a number of discrepancies between accounting standards applicable to banks in Ecuador and IFRS regarding the presentation of the financial statements of banks, such as: the absence of comparative information, either on the face of the financial statements or in the notes; a statement

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<sup>26</sup> In the case of commercial loans, the minimum rates of provision are 1% if less than a month past due, 5% for one-to-three months, 20% for three-to-six months, 50% for six-to-nine months and 100% over nine months.

of financial position in lieu of a cash flow statement; the use of two different charts of account during the fiscal year ended December 31, 2002; etc.

- *Other* – Other requirements of IFRS including the disclosure of earnings per share, fair value of financial instruments, recognition of an asset and a liability on financial leases, etc. are not mandatory under SBS regulation.

In most of the cases listed above, the SBS-prescribed accounting treatment sticks to the legal form of transactions and does not reflect their actual economic substance. Combined with the significantly lower level of disclosure as compared to IFRS, this can cause in certain instances the financial statements to provide a somewhat misleading information.

44. **The review of a sample of financial statements issued by Ecuadorian corporate entities identified a number of cases of non-compliance with applicable accounting principles.** The ROSC review of sample general-purpose financial statements covered 10 listed companies and 5 banks in Ecuador<sup>27</sup>. Although applicable accounting standards in Ecuador are fairly less demanding than IFRS, it appears that, in a number of cases, companies or banks fell short of compliance, as detailed hereafter for the most significant ones:

- *Disclosure of accounting policies.* In many cases, the notes to the financial statements did not include the information on accounting policies required by NEC 1, especially regarding revenue recognition, borrowing costs, inventories, and financial instruments (for banks). Also, in spite of the significant changes in accounting policies (introduction of NEC 18 to 27) occurred during the fiscal year ended December 31, 2002, the explanatory notes did not include the corresponding disclosures required under NEC 5.<sup>28</sup>
- *Shareholders' equity* – Several sampled companies did not disclose information on capital increase and explanations on the purpose of reserves as required by NEC 1.
- *Earnings per share* – This information mandated by NEC 23 was not included or was incomplete in most of the financial statements reviewed.
- *Segment reporting* – In many cases segment information under NEC 8 was not available.
- *Related-party relationships and transactions* – In most instances, the information on related-party outstanding amounts and pricing policies with respect to related-party transactions was incomplete, or absent.
- *Contingent liabilities* – A company has recorded a provision for “maintenance of machinery” involving a material amount, although this type of provision is explicitly excluded by IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, and by its equivalent NEC 26.
- *Intangible assets* – The ROSC review noted that a bank capitalized advertising costs and another one deferred start-up costs over a period of five years. These types of cost are not eligible for capitalization under IAS 38, *Intangible assets*.

Furthermore, there is the case of a listed company whose financial statements for fiscal year 2002

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<sup>27</sup> These financial statements covered the fiscal year ended December 31, 2002 and were made available to the World Bank staff team by the Quito Stock Exchange and the Superintendency of Companies.

<sup>28</sup> Equivalent of IAS 8 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies*.

did not include the required explanatory notes, and which were not audited. In another instance, an auditor issued an opinion on the financial statements of an Ecuadorian-listed company with six qualifications for limitation of scope<sup>29</sup> or disagreement with the accounting treatment applied. This case is all the more worrisome that, as the auditor indicates in his report, the opinion on the previous year's financial statements (i.e., as of December 31, 2001) was already qualified on four matters, including three which were still prevailing in 2002. This situation whereby one of the main listed companies in the country was able to present financial statements without a full clearance from external auditors is uncommon and raises serious concern as to the effectiveness of the Superintendency of companies' enforcement.

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

45. **Ecuadorian Auditing Standards are based on ISA but lag behind them in several key areas.** Ecuadorian GAAS, or NEA, were adopted in 1999 on the basis of ISA, and have not been updated since then. In the meantime the International Auditing and Assurance Standards Board (IAASB) has promulgated the following ISA statements which have therefore no equivalent in Ecuador: ISA 260 *Communication of Audit Matters with Those Charged with Governance*; ISA 315 *Understanding the Entity and its Environment and Assessing the Risks of material Misstatement*; ISA 330 *The Auditor's procedure in Response to Assessed Risks*; ISA 505 *External confirmations*<sup>30</sup>; and ISA 1005 *The Special Considerations in the Audit of Small Entities*. Also, amendments have been made since then to ISA 200 *Objective and General Principle Governing an Audit of Financial statements* and ISA 500 *Audit Evidence*.

46. **The environment within which the auditing process is developed is not conducive to full compliance with auditing standards.** Based on interviews conducted by the ROSC team in Ecuador with various audit firms, auditing practices tend to depart from the standard in several areas, including quality control, the use of sampling techniques, third-party confirmation, management representations, etc. The most significant factors constraining the application of the standards are the lack of:

- *Implementation guidance* – The efforts made in 1999 by the profession to implement the NEA, with the support of audit firms and in conjunction with universities, were short-lived, due in part to a lack of resources. Moreover, no implementation guidelines have been published with regards to the NEA.
- *Quality control and effective sanctions* – As previously noted, there are no mechanisms in place to oversee the compliance with auditing standards and ensure that practicing auditors in Ecuador observe quality assurance procedures in accordance with ISA 220. Also, sanctions are rarely imposed against errant auditors, which weakens the incentive for quality.
- *Governance structure of companies* – Audit committees are believed to play an important role in ensuring that external auditors fulfill their responsibilities to deliver an audit that meets the needs of the stakeholders. However, in the case of Ecuador,

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<sup>29</sup> i.e. areas where the auditor was unable to perform tests required by auditing standards – Refer to paragraph 48 regarding the implications of this case in terms of audit practices.

<sup>30</sup> External confirmation is only required by NEA for accounts receivable while ISA 505 considers other important third-parties such as legal counsels, banks, etc.

audit committees are infrequent as corporate entities are not required to establish them<sup>31</sup>.

47. **The wording of audit reports in Ecuador is somewhat confusing in the description of applicable accounting principles.** In the opinion paragraph, auditors make explicit reference to the GAAP used for preparing the financial statements upon which they render an opinion. In Ecuador, the opinion paragraph normally refers to “generally accepted accounting principles in Ecuador” (or Ecuadorian GAAP), but the following mention “modified in certain aspects by standards and practices authorized by the Superintendency of Companies” is sometimes added. This raises a doubt as to what exactly Ecuadorian GAAP are considered to be by the auditing profession itself. Also, some audit reports include an additional paragraph, after the opinion paragraph, which reads as follows: “The financial statements have been prepared on the basis of Ecuadorian Accounting Standards, which may differ in certain aspects with International Accounting Standards (...)”. This additional paragraph, which is not provided for in the NEA standard dealing with audit reports (NEA 27), is somewhat confusing because a) it refers to the Ecuadorian Accounting Standards (NEC) instead of Ecuadorian GAAP, and b) it appears to play down the difference between NEC and IAS (it should state that NEC significantly differ – instead of “may differ in certain aspects” – from IAS). There is a need to clarify the language of audit reports regarding accounting standards.

48. **The cases of non-compliance with accounting principles identified by the ROSC review were not properly treated in the auditors’ reports.** Regarding the company whose audit report contained six qualifications<sup>32</sup>, one can reasonably question whether the auditor complied with the requirements of NEA 25 *The Auditor’s Report on Financial Statements*, considering that:

- Four of these qualifications related to limitations of the auditor’s scope<sup>33</sup> and involved amounts of such magnitude that they should probably have led the auditor to refrain from issuing an opinion on the financial statements (NEA 25, paragraph 67).
- The two other qualifications corresponded to departures from NEC. Because NEC 1 requires that each individual standard be complied with for the financial statements to be referred to as “prepared under NEC”, and because these departures were material, the auditor should have issued an *adverse opinion* on the financial statements.

Additionally, except for the one discussed immediately above, none of the cases of non-compliance with applicable accounting standard mentioned in paragraph 44 was revealed by the auditors in their reports on the financial statements.

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<sup>31</sup> With the exception of banks and insurance companies from 2004 onward. The Technical Committee of the International Organization of Securities Commissions (IOSCO) has issued a statement dealing with audit committees in October 2002, which could serve as reference for Ecuadorian authorities.

<sup>32</sup> Refer to paragraph 43 above.

<sup>33</sup> For instance, the auditor had not been able to check the reconciliation of the inventory as per the books of accounts with the corresponding physical count.

## V. PERCEPTION OF THE QUALITY OF FINANCIAL REPORTING

49. **Users of financial statements in Ecuador generally acknowledge the improvements brought by the introduction of NEC. However, many still consider the overall quality of the financial reporting to be insufficient**<sup>34</sup>. Among those interviewed in connection with the ROSC assessment, a majority of users of financial statements consider the introduction of the NEC in 1999 as a significant step forward for Ecuador's corporate financial reporting. Nonetheless, most of them still consider the reliability of financial statements issued by corporate entities to be fair or poor and the quality and adequacy of the financial information to be insufficient. The main areas where users have expressed such concern included:

- The lack of consolidated financial information, as they were not mandatory up until 2003;
- Finance leases, for which no debt is recognized on the balance sheet as permitted by NEC;
- Disclosure of related-party transactions;
- Disclosure relating to contingent liabilities;
- The influence of tax rules on financial statements of SMEs;
- The absence of half-year financial statements as they are not mandated by law or specific regulation.

50. **Further convergence of the standards toward IFRS is seen as a condition to achieve quality financial statements.** Investors, banks and other users of financial statements interviewed recognized that the current limitations of Ecuador's accounting principles constitute a clear impediment to the overall quality of the financial information. Most of them suggested that NEC be further expanded to cover the areas for which no standard has been adopted and which are critical to the quality and usefulness of the financial statements.

51. **Effective enforcement is also a major concern for financial statement users.** A majority of users of financial statements interviewed consider that, beyond the issue of the standards themselves, the current regulatory oversight structure does not ensure compliance with those standards, and should therefore be improved.

## VI. FINDINGS AND RECOMMENDATIONS

### A. Findings

52. Ecuador's private sector accounting and auditing standards are incomplete and unevenly complied with. As a result, the actual and perceived quality and reliability of the financial information in the private sector is relatively low. The main findings of this ROSC review of accounting and auditing practices are:

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<sup>34</sup> These findings are based on interviews conducted by World Bank staff as part of the ROSC accounting and auditing review in Ecuador. Those interviews involved various Ecuadorian stakeholders, including banks, brokerage firms, investment funds, universities and experienced audit practitioners.

- Consistent with the situation observed in most Latin American countries, the public sector plays an essential role in setting and enforcing accounting and auditing standards in the private sector.
- The country's existing legal framework appears to provide an adequate basis for strengthening financial reporting practices in the near and medium terms, although reforms may be needed in the longer term.
- Ecuador's accounting standards (NEC) have not been updated since 2000 and do not cover several important and often sensitive types of transactions. This limits the quality of the financial statements and does not enable them to be relied upon by international investors. Eventually, it is harmful to investors' confidence and also contributes to limit access to long term financing especially by SMEs.
- Although financial statements are prepared and in many instances audited, there is no obligation to publish them. As a result, except in the very rare cases of voluntary publication, only regulators and shareholders have access to that information. This hampers banks' access to comparative data across a particular sector and therefore can limit the effectiveness of their lending activities. Also, there is no obligation to prepare interim financial information, let alone financial statements reviewed by independent auditors. This lack of accessibility of required information gives the appearance of collusion between regulators, auditors and company management and seriously hinders the impact of the financial reporting process. Ultimately, it creates an environment of opacity which is not favorable to the investment climate or for enterprises to obtain financing.
- Private sector financial reporting and auditing is regulated by two Superintendencies. Also, because a very large share of the state's revenues is derived from those entities which are subject to statutory audits, the SRI plays is actively involved in this process. However, there is little coordination between the regulators, especially with respect to the licensing and monitoring of auditors.
- As shown by the ROSC review of financial statements, enforcement of accounting and auditing standards by the regulatory agencies is insufficient, particularly in the case of the Superintendency of Companies. This is also illustrated by the very limited number of sanctions taken against errant auditors. Factors hampering a more effective enforcement include inadequate systems and a lack of focus in monitoring the accounting and auditing process; scarce resources and insufficiently trained personnel. Commendable efforts have been made to address these problems within the SBS, and these efforts should be continued.
- The profession has adopted auditing and ethical standards of internationally acceptable quality, although they need some updating. Also, the SBS requires the use of ISA for the audits of financial institutions and insurance companies.
- However, current academic curricula do not provide sufficient assurance that the majority of would-be auditors have been adequately prepared to apply the standards. Further, insufficient licensing requirements, the absence of quality control mechanisms, and rarely imposed sanctions are additional impediments to compliance with the standards.
- Audit committees are uncommon among Ecuadorian companies as governance arrangements appear to be still in transition between family control and a larger stakeholder ownership. Enhancing the country's investment climate will require an

adjustment of Ecuador's corporate rules and practices consistently with international trends, especially in respect of the role of the board of directors, audit committees and the *comisario*.

53. The policy recommendations presented hereafter are for the most part enabled by the current legislative framework (including LMV and LGISF), as this was developed relatively recently, and it takes account of current practices and technology<sup>35</sup>. Legislative reforms may be needed in the longer term, and this matter should be further reviewed as part of other analytical studies, including possibly a Corporate Governance ROSC. These recommendations will be presented to the country stakeholders on occasion of a workshop in Quito, before finalization of the report. Stakeholders' reactions will be incorporated into a Country Action Plan to be developed under the supervision of the Ministry of Economy and Finance (MEF), with the support of the World Bank and other international development partners—including IDB/MIF. These recommendations entail potential economic benefits for a wide range of Ecuadorian stakeholders, including:

- Achieving greater financial transparency in the private sector, for a relatively limited incremental cost since a significant amount of the information already exists—in the form of audited financial statements—but is not presently made available to the public.
- Increasing the quality of statutory financial statements and facilitating their public availability can help improve the lending activities of commercial banks by allowing comparative analysis of financial data within the same sector.
- Enhancing the quality of audits can also build-up the market's confidence in the reliability of the financial information and thereby contribute to reducing the cost of financing for Ecuadorian enterprises.
- From the public sector's standpoint, the proposed measures to reinforce accounting and auditing practices in the corporate sector would support the SRI's efforts to limit corporate income tax evasion in the country.
- Finally, workers can also derive a benefit from strengthened accounting and auditing practices as they have an important stake in knowing the state of affairs of the company who employs them. Moreover, since Ecuadorian law entitles them of a share of company earnings, improvement of accounting and auditing practices is also in their interest as it provides additional assurance that those earnings are properly assessed.

## B. Policy Recommendations

54. **Adopt IFRS and mandate their use for all public-interest entities in Ecuador. This evolution would reflect Ecuador's drive toward further economic integration on an international level, including within the Latin American region<sup>36</sup>.** Ecuador has chosen the path toward convergence by developing the Ecuadorian Accounting Standards (or NEC) in 1999 and 2000 on the basis of IAS. However, as previously noted, the NEC left out significant types of

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<sup>35</sup> Also, attempts to reform existing legislations could bear certain constitutional implications, especially with respect to the role of the Superintendencies or the organization of the accounting profession.

<sup>36</sup> A *White Paper on Corporate Governance in Latin America* recently issued by the Organization for Economic Cooperation and Development (OECD) recommends adopting IFRS on the basis of a survey of a wide range of Latin American stakeholders.

transactions and other aspects of the financial reporting, which has an adverse effect on the quality of the financial statements and perception by those who use the financial statements. The best solution for Ecuador appears to be adopting IFRS, which will provide the country's public interest entities and stakeholders with a clear set of standards and will also enable the country to benefit from the resources and international recognition entrusted to the IASB<sup>37</sup>. This evolution would support Ecuador's effort to improve its competitiveness and investment climate. IFRS should be mandated for all public-interest entities, i.e. entities with specific accountability toward the public interest, such as listed companies, banks, insurance companies, state-owned enterprises, as well as those entities bearing significant importance to the country due to their size or nature of business<sup>38</sup>. Adopting IFRS will require a decision by the MEF, and would entail the following changes to the current regulatory and institutional framework<sup>39</sup>:

- ***Establish an independent body officially empowered with setting accounting standards for all corporate entities in Ecuador.*** While adopting IFRS would contribute to significantly streamline the standard-setting process, several steps will still have to be handled by Ecuadorian stakeholders themselves, such as: translating the standards issued by the IASB and related interpretations by IFRIC, promulgating the translated standards and interpretations, issuing guidelines for implementation of the standards, and ruling on specific cases upon request from companies, auditors or regulators. Accordingly, at the initiative of the Government, an independent, self-regulated body should be established with delegated powers from the various institutions that are empowered with setting accounting standards under Ecuadorian law. This body should have a diverse private sector membership, and a large representation of the public interest. The way it would operate will be defined during the Country Action Plan workshop<sup>40</sup>. Establishing this standard-setting body would bring the following benefits to the country:
  - *Stakeholders' commitment to the accounting standard-setting process* – Involving all stakeholders (regulators, the accounting profession, companies, investors, etc.) in the standard-setting process would enhance their commitment toward high quality financial information.
  - *Timeliness and due process in setting the standards* – The independent standard-setting body's by-laws would provide for mechanisms to ensure proper consultation, and quality control mechanisms. The by-laws would also provide for timely issuance of the translated standards and responses to any queries on specific issues by preparers or auditors of financial statements.
  - *Clarity* – Adopting IFRS for all general-purpose financial statements of public-interest entities would clarify users' understanding of, and confidence in, applicable standards.
  - *Regional synergies* – In order to ensure maximum comparability among Latin American countries using IFRS and considering the costs associated

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<sup>37</sup> It is worth noting that a project is currently under way within the IICE for the adoption of IFRS in Ecuador. This project is supported by the Inter-American Development Bank (IDB), with partial funding provided by the Multilateral Investment Fund (MIF).

<sup>38</sup> Country authorities would have to precisely define which entities would be considered of public interest in the context of Ecuador.

<sup>39</sup> In addition to some Technical Assistance as discussed in paragraph 63.

<sup>40</sup> The financial reporting standard-setting body recently established in Mexico provides a relevant model for Ecuador.



with it, the standard-setting process should be conducted with some degree of coordination with other Spanish-speaking countries<sup>41</sup> – possibly with the support of the Inter-American Accounting Association (AIC), or within other regional fora. In that respect, establishing cooperation arrangements with sister standard-setting institutions in other countries could be mutually beneficial.

- ***Provide simplified accounting and financial reporting standards for small and medium enterprises (SMEs).*** It is commonly acknowledged that legislation should set requirements for SMEs commensurate with their size, types of transactions, and a more limited range of stakeholders. In this perspective, the IASB has initiated a project to issue a standards dealing with *Financial reporting by small and medium-sized entities*. The IASB has recently announced that it would release a discussion document in the second quarter of 2004. In this context, SMEs in Ecuador should continue to follow NEC until IASB releases an international “SME standard”. By improving the quality of the financial information they produce, Ecuador’s SMEs will gain easier access to credit, which in turn will help boost their development.
- ***General-purpose financial statements of financial institutions and insurance companies should be prepared under IFRS.*** General-purpose and regulatory financial statements fundamentally share the same objectives. However, in fulfilling their responsibilities to ensure proper functioning of the sector under their purview, regulators normally issue prudential accounting rules on certain types of transaction that may not be compatible with GAAP. Accordingly, the SBS should require banks, insurance companies to prepare a set of financial statements in accordance with IFRS and, separately, any additional financial information needed for regulatory purposes.<sup>42</sup>

55. **Enhance financial transparency in the financial and corporate sectors by facilitating the availability to the public of financial statements and increasing their frequency.** The Superintendency of Companies and the SBS should make the audited financial statements under their purview – especially those of listed companies, banks and insurance companies – available to the public, possibly by posting them on their websites. Moreover, public-interest entities should be required to provide shareholders and the general public with half-year financial statements reviewed by independent auditors. This will help create an environment of increased transparency and contribute to improve the investment climate and the efficiency of Ecuador’s securities market.

56. **Adopt ISA and update the accountants’ code of ethics.** The auditing standards currently used in Ecuador are either the NEA, which correspond to ISA as they prevailed in 1998, or ISA themselves in the case of banks and insurance companies. Consequently, the principle of adopting international standards should not pose any difficulty to the auditing profession in Ecuador<sup>43</sup>. The Superintendency of Companies should therefore issue a resolution requiring the financial statements of listed companies and other entities under its purview to be audited in

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<sup>41</sup> Especially countries that officially recognize IFRS.

<sup>42</sup> An alternative to providing additional information would be for regulated entities to prepare a separate set of financial statements following the regulators’ special rules and containing reconciliation with general-purpose financial statements.

<sup>43</sup> The adoption of ISA is also contemplated as part of IICE’s current convergence project with IDB/MIF support.

accordance with ISA. Furthermore, the current code of ethics should be amended in line with the latest version of IFAC's Code of Ethics for Professional Accountants. Here too, there would be clear benefits for Ecuador to cooperate with other Spanish-speaking countries to share the translation effort and achieve common standards at regional level.

57. **Establish a public oversight body of the audit profession.** Auditors have a distinctive responsibility toward the users of financial statements, including shareholders, regulators, and the public in general. Failure to fulfill that responsibility can have detrimental effects for those users and to capital markets or the financial sector as a whole, thereby damaging the investment climate and private sector competitiveness. Hence, the audit profession's traditional self-regulatory regime characterized by limited enforcement of applicable standards, should give way to independent oversight, consistent with the trend observed on an international level.<sup>44</sup> In the case of Ecuador, an "Audit Oversight Board" should be formed either through a change of the Corporations Law and other relevant acts, or more conveniently through a formal delegation by those institutions currently entrusted with regulating the profession of public accountants— i.e., the Superintendency of Companies, the SBS and the SRI. This would not only allow to draw synergies in the monitoring of auditors but also help regulators focus their resources on their own enforcement activities. As in the case of the accounting standard-setter, the conditions under which the audit oversight board would carry-out its missions, will be set-out in the Country Action Plan. Auditors' oversight would entail, among others, the following missions:

- ***Qualification of auditors.*** The license of auditors would be awarded by the Audit Oversight Board to those professionals meeting strict requirements. The latter should include a professional examination and demonstrating sufficient experience in the audit practice, consistent with internationally observed best practices and IFAC's recommendations. Also, a pre-requisite to the examination to obtain the license of auditor should be a university degree of *contador público* (or university degrees with equivalent accounting and auditing contents). Also, auditors seeking renewal of their license should be required to have adequately updated their knowledge of accounting and auditing standards.
- ***Enforcement of auditing and ethical standards.*** The oversight board, governed by a majority of non-practitioners, should monitor practicing auditors through on-site inspections to ensure that these auditors have set-up quality assurance arrangements and effectively apply ISA and ethics code. Disciplinary proceedings should be conducted for identified cases of non-compliance.
- ***Fostering efforts by the profession to increase the quality of the audits.*** Based on interviews with audit practitioners in Ecuador, it appears that the ability of auditors to achieve high quality audits is constrained by a lack of implementation guidance and insufficient resources, particularly for individual auditors or small audit practices which do not benefit from the technical support of large international audit firms. In that sense, the oversight board, in cooperation with representatives of the profession including the IICE, and the academic community, should develop guidelines and

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<sup>44</sup> Examples of recently introduced national independent oversight bodies include the Canadian Public Accountability Board, *Haut Conseil du Commissariat aux Comptes* in France, Irish Auditing and Accounting Supervisory Authority, and Public Company Accounting Oversight Board (PCAOB) in the United States. Spain for its part has such oversight body (*Instituto de Contabilidad y Auditoría de Cuentas*) since 1989. This would also follow the model adopted by IFAC in 2003, with the introduction of a Public Interest Oversight Board (PIOB). The PIOB's mission includes to "ensure that the standard-setting and compliance activities of IFAC are conducted in a manner which is consistent with the public interest, in order that the public can have confidence in financial reporting."

information technology tools supporting the performance of the audits and related quality control procedures. The overall quality of the audits, especially among SMEs, would benefit from the introduction of such guidelines and tools.

- **Enhancing the image of the audit profession.** Increasing the visibility and recognition of the audit profession in the country would contribute to strengthening the confidence in audited financial information on the part of users on both a domestic and an international level. In that respect, board's membership should include experienced and well-reputed professionals in various fields including accounting and auditing, finance, banking, law, business administration, with some members working on a full-time basis. Also, the board should be able to develop institutional relations with key stakeholder groups, including relevant regulatory bodies, the accountancy profession, business and investor community, academia, professional bodies, etc., as well as cooperation with equivalent authorities in other countries. Publishing an annual report evaluating the performance and progress of the auditing profession may also contribute to a stronger image of the profession.

58. The Country Action Plan should establish whether or not the oversight board and the aforementioned independent standard-setting body should in fact form a single institution. The main benefits of that would be economies of scale, better coordination and the fact that qualified candidates for board membership—including civil servants with adequate experience in the field of accounting or auditing, former audit practitioners with relevant background, etc.—may be in limited supply. On the opposite, having two entities would be consistent with the distinct purposes and constituencies involved: on the one hand, accounting standard-setting deals exclusively with accounting standards and is directed toward a wide group of stakeholders (preparers, auditors, enforcers and users); it entails mostly research and consultation. On the other, the auditor oversight involves mostly inspections to ensure audit practitioners' compliance with auditing, ethical and educational standards.

59. **Strengthen academic curricula in the field of accounting and auditing, as well as professional education and training.** In order for future practitioners – specially would-be auditors – to have sufficient academic background in the field of accounting and auditing, the university curricula leading to the degree of *contador público* should be harmonized at national level. In that regard, the government agencies involved in the accreditation of university degrees should establish guidelines consistent with IFAC's recently issued International Education Standards for Professional Accountants (IES)<sup>45</sup>. Furthermore, professional accountants should be required to follow training programs to improve and update their knowledge of international standards and best practices in the field of accounting and auditing.

60. **Establish legal requirements for governance mechanisms within public-interest entities dealing with external audits.** As noted before, the SBS has mandated the creation of audit committees within banks and insurance companies, beginning in 2004. Indeed, audit committees can play an important role in monitoring the effectiveness of the audit process, especially with regards to auditor's compliance with independence requirements. Thus, applicable legislation (corporate law, LMV, etc.) should be amended in such a way that all public-interest companies in Ecuador be required to establish an audit committee or similar governance body. The audit committee would be responsible to ensure the transparency of the audit process,

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<sup>45</sup> Especially IES 1, *Entry Requirements to a Program of Professional Accounting Education* and IES 2, *Content of Professional Accounting Education Programs*.

including the appointment and remuneration of independent auditors. Also in that regard, a ROSC assessment of corporate governance practices should be conducted in Ecuador.

### C. Institutional Capacity and Training

61. **Strengthening the enforcement of applicable accounting standards** – The quality of corporate financial reporting depends not only on established accounting standards but on the effective enforcement of those standards. As noted by the ROSC review and as confirmed by the perception of financial statements users, there is a compliance gap with regards to accounting principles in Ecuador. Also, IFRS are more demanding than the NEC, in that it requires the recognition of certain transactions or a higher level of disclosure in the financial statements. Hence, Ecuadorian public-interest entities may have difficulties complying with IFRS requirements once they are enacted. Consequently, monitoring compliance with accounting standards should be strengthened, especially on the part of the Superintendency of Companies, through:

- **Increased enforcement capacity of regulatory agencies.** Regulators should have the resources to perform in-depth analysis of corporate financial statements and conduct on-site inspections. In view of that, Technical Assistance involving consulting will be needed for adjust the structure and organization of the Superintendency of Companies in such a way to focus its activities on listed companies and other entities of public interest. Additionally, the staff of the regulatory agencies needs to receive training so that they would be in a position to effectively enforce compliance with IFRS.
- **Transparency and due process in the conduct of enforcement.** The monitoring of compliance with financial reporting requirements should follow clear and transparent procedures. Also, the conclusions of reviews and on-site inspections by the regulators, including any request for change of the financial statements or recommendations for improvement, should be formalized and made public. This would help deter non-compliance with applicable standards on the part of companies and auditors.
- **Sanction in case of non-compliance.** In addition to making public the findings from the enforcement of the standards, there should be effective administrative sanctions against non-compliant companies or auditors, as permitted by the Corporations Law, the LMV and the LGISF.

Detailed measures for achieving these improvements and outline of corresponding technical assistance will be provided in the Country Action Plan.

62. **Establishing the independent accounting standard-setter and the Audit Oversight Board** – The first step in creating these two independent bodies should be to define the by-laws or terms of reference under which they will operate. For the accounting standard-setting body, these would include: procedures for selecting and appointing members; approving proposed translations of international standards; etc. As for the auditors' oversight body, key processes to be addressed include: setting-out auditor licensing and quality control requirements, a program to conduct inspections of audit firms and individual auditors, communication and resolution of findings arising from the inspections, etc. Technical Assistance will be needed to precisely design those processes as well as for the corresponding recruitment, preparation and training efforts for the permanent staffs of the two institutions to be established. The content, cost and funding of this

Technical Assistance, as well as the recurring budget of the two institutions, will be dealt with in the Country Action Plan.

63. **Other actions to support the reinforcement of the audit practice in Ecuador.** As previously discussed, the FNCE is proposing to phase-out the *contadores bachilleres* after a period of transition, through the new Law of Accountants currently being discussed. In order to facilitate the transition and avoid a shortage of authorized accountants in the country, the Country Action Plan should include incentives for *contadores bachilleres* to complete the necessary continuing education so as to acquire the title of *contador público*.

64. The Technical Assistance needed to support the policy recommendations presented above is expected to be relatively modest, consisting mainly in a) designing the processes under which the two new self-regulatory bodies would operate and the existing regulators would conduct enforcement actions, b) drafting the corresponding regulation and c) other related human resources issues. As for the training to build-up the capacity of the regulators and to establish the standard-setting and oversight bodies, it is expected to be substantial.

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