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REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)

Egypt, Arab Republic

ACCOUNTING AND AUDITING

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Contents

EXECUTIVE SUMMARY

During the past decade, Egypt made significant efforts to align corporate financial reporting requirements with the International Accounting Standards (IAS) and to close the "compliance gap" in both accounting and auditing practices. Consequently, important improvements have been achieved in accounting and disclosure requirements for the publicly traded companies and financial institutions and in Egyptian Accounting Standards as benchmarked against IAS. Moreover, a new Accounting Practice Law has been drafted and agreed upon by all stakeholders, though not yet been ratified. Further improvements could be achieved by issuing a modern legislative framework that includes an appropriate regulatory framework for practicing auditors, addressing weaknesses in professional education and training arrangements, introducing qualification examinations for auditor licensing, and developing an enforcement mechanism to ensure compliance with applicable accounting and auditing standards.

Building on past reform, greater efforts are required to assure comprehensiveness and coordination among major stakeholders. There is an urgent need to design and implement a comprehensive action plan for accountancy reform and development. This report provides inputs for such an action plan. The report highlights the need for an institutional framework that underpins accounting and auditing practices—setting up standard-setting arrangements for full adoption of international accounting and auditing standards, with particular focus on development and dissemination of practical implementation guidelines; strengthening enforcement mechanisms; upgrading professional education and training, including implementation of international best practice on auditor qualification examinations; and establishing an efficient and effective regulatory framework for practicing auditors.

The Government of Egypt should consider establishing an accounting and auditing oversight body, which would be charged with the oversight of the public interest activities of practicing auditors, and the efficacy of the institutional framework for supporting high quality financial reporting.

This report was prepared by a team from the World Bank on the basis of the findings from a diagnostic review carried out in Egypt in May 2002. The information provided in this report was updated in December 2002. The team comprised M. Zubaidur Rahman (OPCFM), and Samia Msadek and Hisham Waly (MNACS). The review was conducted through a participatory process involving various stakeholders and led by the country authorities.

I. INTRODUCTION

1. This report was based on a review of accounting and auditing standards and practices in Egypt. It forms 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 process involved an assessment of accounting and auditing standards as designed and as practiced, and analysis of effectiveness of the mechanism for ensuring compliance with formal standards. The review used a diagnostic template developed by the World Bank to facilitate data gathering by national specialists. This was complemented by a due diligence exercise conducted by World Bank staff.

2. Egypt has a history in the field of financial management and accountability. During the 1960s, with the movement toward economic management based on central planning, nationalization, and rapid expansion of the public sector, the Central Auditing Organization became the governmental agency responsible for auditing the public sector, including state-owned companies. In the mid-1970s, the Egyptian government introduced an “open-door” policy to liberalize the national economy; in 1991 the government launched a comprehensive Economic Reform and Structural Adjustment Program supported by the World Bank and the IMF. Egypt is aware that sustaining such a program depends on the existence of a sound financial regulatory framework, availability of credible corporate information, and adoption of internationally accepted accounting and auditing standards. As part of these efforts, the Egyptian Government launched several initiatives to reform corporate financial reporting and disclosure requirements, as well as accounting and auditing standards and practices, but these improvements have yet to be finalized.

II. INSTITUTIONAL FRAMEWORK

A. STATUTORY FRAMEWORK

3. **The draft of a new Accounting Practice Law has been under discussion for about five years.** The delay in finalizing a new Accounting Practice Law has stalled efforts to improve accounting and auditing practices. Drafting the new law began about five years ago under the sponsorship of the Ministry of Finance, the Syndicate of Accountants in Egypt,[1] and the Egyptian Society for Accountants and Auditors. Important features of the draft law include introduction of a professional qualification examination for accountants, recognition of audit firms and individual auditors as providers of statutory audit services, emphasis on coordination among professional accountancy organizations through the creation of a council for accounting and auditing, and enhancement of auditors’ independence through a mechanism to resolve disputes between auditors and corporations. The draft law lacks important elements that could strengthen the auditing regulatory framework, for example, the need for continuing professional education. These deficiencies can be covered in the law itself or in the executive regulation.

[1] All accounting degree holders are eligible for Syndicate membership.

4. **At present, the principal law governing professional accountants and auditors, particularly in the private sector, is Accounting Practice Law 133/1951 and its amendments, which are deemed outdated by most practitioners**. According to current law, individuals joining the public practice of accounting and auditing must register with the General Register (Registry) for the Accountants and Auditors, which is maintained by the Ministry of Finance and does not require a qualifying examination for entry. The current law provides a broad framework for bookkeeping and financial reporting, and authorizes the Ministry of Finance to develop a standardized chart of accounts and detailed instructions on the accounting treatments and reporting formats. The legal approach, which was taken in the early 1950s for establishing a uniform accounting system, constrained the development and application of accounting standards that are conducive to high-quality financial reporting in a market economy.

5. **The Company Law 159/1981 requires all companies to prepare annual audited financial statements.** All companies registered under the Company Law should maintain sound accounting records and present annual audited financial statements.[2] According to the Company Law, the annual general meeting of shareholders should monitor auditor performance, and appoint a new auditor or renew the appointment of the existing auditor. In the case of bank audits, the Central Bank of Egypt monitors performance of auditors and reviews auditor's report and annual financial statements prior to presentation at the shareholders' general meeting. The Company Law also requires the auditor to report the following at the annual general meeting: (a) that all data and explanations for satisfactory fulfillment of duties have been obtained, (b) that the company maintains satisfactory accounting records, (c) that all relevant legal requirements have been reflected in the accounts, (d) that the financial statements provide a true and fair view of the company's financial condition and results of operations, and (e) that the inventory has been recorded in conformity with applicable rules. The Company Law does not cover accounting and auditing standards, but requires that external audits should be conducted in compliance with the Accounting Practice Law 133/1951. According to provisions of the Company Law, the auditor or relatives of the auditor must not be a founder, director, permanent consultant, or employee of the auditee. However, there is no restriction on shareholders being appointed as external auditor of the company.

6. **According to the Capital Market Law 95/1992, all listed companies are required to follow Egyptian Accounting Standards.** Originally the Capital Market Law required that all listed companies prepare financial statements in compliance with the International Accounting Standards (IAS).[3] Ministerial Decree 503/1997 mandated the use of Egyptian Accounting Standards by all enterprises regulated by the Capital Market Authority.[4] However the introductory paragraph of the Decree states that in the absence of

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[2] A draft amendment to the Company Law, which is under discussion, includes provisions requiring all companies to observe the same accounting standards as are applicable for companies regulated by the Capital Market Authority. Moreover, these provisions specify the rights and duties of company auditors.

[3] There are about 1,100 listed companies, of which about 100 are actively traded companies. For receiving tax benefits, about 900 companies that are virtually closely held, got listed in the Stock Exchange, but their securities are hardly traded.

[4] The Ministerial Decree 503/1997 was issued by the Ministry of Economy and Foreign Trade, which was the supervising Ministry of the Capital Market Authority. The name of the Ministry has been changed to

Egyptian Accounting Standards, regarding any accounting treatment, the requirements set by IAS will apply. The Capital Market Law requires all listed companies to file annual and semiannual audited financial statements and quarterly financial statements with the Capital Market Authority and the Cairo and Alexandria Stock Exchange. The quarterly financial statements require limited review by auditors. The Capital Market Law also requires listed companies to publish financial statements in two widely circulated newspapers. This requirement may be counterproductive and unhelpful to users of financial information when only summarized financial statements without detailed notes are published in the newspaper. The Capital Market Authority has recently drafted a new Capital Market Law. This draft—released for public comment—includes provisions on various administrative sanctions against violators of financial reporting and disclosure requirements.

7. **The new Listing Rules have introduced enhanced administrative actions against those issuers who do not comply with the reporting requirements.** The new Listing Rules approved by the Capital Market Authority became effective August 1, 2002. The rules aim to ensure timely preparation and presentation of financial statements and full compliance by the issuers with accounting, auditing, and other legal requirements. According to these rules, the Capital Market Authority can impose an administrative penalty of Egyptian Pounds (EGP) 5,000[5] if the issuer failed to disclose information that resulted in losses to investors. The penalty could be doubled in case of recurrent nondisclosure during the same year. If companies do not file with the Capital Market Authority and publish financial statements and other required information on a timely basis, a fine of EGP 500 is imposed for a delay of up to five days. For further delay, an additional fine of EGP 100 per day is imposed. In case of delay exceeding 30 days, the Stock Exchange is authorized to consider delisting the company. According to the new rules, all listed companies are required to establish an Audit Committee with the objective of strengthening corporate governance and improving financial reporting.

8. **The Banking Law requires all banks to follow accounting and auditing requirements and guidelines set by the Central Bank of Egypt.** The Central Bank issues guidelines to banks on financial reporting and requires them to follow the Egyptian Accounting Standards. The Central Bank also requires banks to file annual, semiannual, and quarterly reports, including financial statements. Regulations, which aim at ensuring audit quality, state that two licensed auditors must audit bank financial statements, and individual auditors cannot sign audit reports for more than two banks per year. According to the law, both signatories are allowed to be partners of the same audit firm.

9. **Audit firms cannot be appointed statutory auditors of companies.** According to Egypt's current legislative framework, only licensed individuals can act as auditors. In practice, companies appoint individual partners of audit firms so that in the case of a bad audit, the audit firm cannot be held liable.

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the Ministry of Foreign Trade, which continues to issue accounting and auditing requirements for all enterprises falling under the regulatory framework of the Capital Market Authority.

[5] At the end of March 2003, EGP 5.6 equaled US$1.00.

10. **The Central Auditing Organization is responsible for the audit of state-owned enterprises.** The Central Auditing Organization Law 144/1988 governs the auditing of government departments and agencies, public sector enterprises, and companies in which ownership interest of public investment is not less than 25 percent. The Central Auditing Organization submits its reports to the People's Assembly (Parliament), which remits them to specialized committees for review. The Central Auditing Organization has taken important steps toward harmonization of public sector accounting and auditing standards with the internationally accepted standards. The capacity of the Central Auditing Organization needs to be strengthened to improve compliance with internationally accepted public sector accounting and auditing standards.

11. **State-owned companies listed on the Stock Exchange operate under the direct guidance of the Ministry of Finance.** The Ministry provides circulars, sample budgets, and forms of financial reporting. Through this process, the Ministry monitors operating performance, evaluates progress, and rationalizes costs and inventory holdings of the state-owned companies. Furthermore, the Ministry of Finance and the Central Auditing Organization work together to ensure that state-owned companies comply with accounting and auditing requirements**.**

B. The Profession

12. **The Egyptian Society of Accountants and Auditors plays an important role in the accountancy profession. However, it functions like an elite body of accounting professionals.** The Egyptian Society of Accountants and Auditors (the Society) is an association of chartered accountants that develops educational and professional standards for its approximately 1,200 members. About 700 members are actively involved in auditing practice. The Society is a member of the International Federation of Accountants (IFAC). However, the Society does not function as a self-regulating body in line with the recommendations of IFAC, as exemplified by its lack of a disciplinary committee with power to ensure its members comply with rules of professional conduct. A Royal Charter in 1946 established the Egyptian Society of Accountants and Auditors. It was given further statutory recognition by the Ministerial Order No. 2280. The Society is run by a board of directors and is constituted under its own statutes. Members are admitted when they meet one of the following requirements: (a) membership in the Institute of Chartered Accountants in England and Wales, or another acceptable foreign professional body (provided they pass the Society's examinations on Egyptian tax law and Egyptian company law); (b) doctoral degree in accounting with three years of experience in practice; (c) at least three years of full-time work experience in the office of a practicing Society member, and successful completion of the Society's two-part examination. (The first part, an intermediate examination, is taken after one-and-a-half years; and the second final part is taken at the end of three years.)

13. **According to existing law, the Registration Committee for Accountants and Auditors in the Ministry of Finance is responsible for registering professional accountants and auditors.** The Registration Committee has a list of more than 30,000 registered accountants who provide auditing services. Registration rules stipulate that a graduate with a bachelor's degree and a major in accounting may register as a trainee

accountant. Trainees qualify for first-level registration as accountants after three years of professional work in a practicing accountant's office or equivalent,[6] which authorizes them to practice as auditors of sole proprietorships and partnership enterprises. After an additional five years of employment experience, accountants apply to the Registry for a final registration certificate, which is the license to act as auditor of joint stock companies. Candidates for final registration certificates are not required to take qualifying or competency examinations before their names are listed in the Accountant Registry. Candidates can also register directly through membership in the Egyptian Society of Accountants and Auditors, which also qualifies them for a license to audit joint stock companies. At present, many practicing auditors, who are not members of the Egyptian Society of Accountants and Auditors, lack necessary professional competence for providing high-quality auditing services.

14. **There is no effective code of ethics for professional accountants and auditors.** The code of ethics was developed for Egyptian accountants in 1958 and the Syndicate's Law 40/1972 discusses ethics violation criteria (such as negligence or fraud). Many practicing accountants and auditors have never reviewed these requirements for practical implementation, despite the fact that the Ministry of Finance and the Syndicate have been making efforts to increase awareness of legal requirements. The audit practitioners are not required to follow any modern code of ethics in line with IFAC Code of Ethics for Professional Accountants. In practice, there is little awareness among many practicing auditors of international best practices concerning conflicts of interest and auditor independence.

C. Professional Education and Training

15. **Professional standards for accountants and auditors need to be improved by raising the quality of public university education and by introducing a professional qualifications examination.** Educational quality suffers from lack of modern curricula and too few teachers for too many students. The accounting curriculum needs to be updated. Undergraduate-level accounting and auditing courses focus on elementary topics and application of standards, but do not include international standards and practices. Although many faculty members have been educated in America and Europe, they lack appropriate textbooks and educational materials in international accounting and auditing standards. Outdated curricula and lack of appropriate learning materials diminish student's knowledge of modern accounting and auditing. Academic programs are not improving students' critical thinking. Moreover, the teacher-student ratio in accounting departments of large public universities is about 1 to 1,000, which hinders instructional quality and constrains essential teacher-student communication. All these factors contribute to deteriorating quality of accounting programs in public university education. At the post-graduate level, the quality of accounting education is relatively better because the

[6] The jobs that are deemed to be equivalent to working in a practicing accountant's office include (a) Central Auditing Organization's auditor, (b) tax inspector, (c) social insurance inspector, (d) Ministry of Finance staff dealing with the preparation of financial statements or budgets, (e) inspector in the Ministry of Foreign Trade, (f) staff dealing with financial matters in the Ministry of Tourism or other government departments, and (g) financial controller working for companies exceeding certain minimum-size thresholds.

curriculum includes international accounting and auditing standards and encourages empirical research.

16. **Private universities offer quality accounting education, but the best students rarely join the public accounting profession in Egypt.** The American University in Cairo now offers an accounting major within the business administration department. This program combines American teaching systems with Egyptian requirements. Its graduates become well-rounded accountants who are frequently employed by multinational organizations. However, with so few graduates, the program has no impact on the national accounting profession. Private universities now offer English-language accounting programs using internationally comparable curricula and English-language textbooks. But extremely high tuition fees for private universities are restrictive, giving access mostly to the wealthiest students. A few public universities, including Cairo University, have started an English-language section in the accounting department; but the few graduates are unlikely to have significant impact in the public accounting profession. Experience shows that high-quality university graduates, especially those with English-language capability, generally do not join the public accounting profession in Egypt, primarily because the reward and remuneration structure in the profession is not competitive.

17. **The length of apprenticeship required by law to qualify for registration with the General Register for Accountants and Auditors does not ensure proper or adequate practical knowledge to the auditor-trainee.** The registration requirement is considered met if the applicant simply produces a letter from an employer stating that the applicant has worked for a practicing licensed accountant or equivalent throughout the stipulated apprenticeship period. The application and the employer's letter are not subject to verification. Moreover, there is no verification that the applicant has participated in any actual audit assignment during the apprenticeship period. The requirements for licensing registration should be upgraded so that trainee-auditors receive practical training only from the authorized and capable audit firms who can verify the work experience.

18. **The knowledge gap of practicing auditors is increased by the absence of any requirement for continuing professional education.** The Accounting Practice Law does not require licensed audit practitioners (i.e., certificate of registration with the General Register) to undertake regular training or continue their professional education. The Egyptian Society of Accountants and Auditors, which has established qualification examination requirements, does not require continuing education for members. International best practice stipulates that every practicing auditor should complete at least 30 hours of continuing professional education per year to help keep pace with new developments in auditing and accounting.

19. **The Egyptian Society of Accountants and Auditors has begun a learning initiative for candidates taking Society examinations.** The Society Chairman expressed concern about the inadequacy of academic training and lack of knowledge of most accounting graduates in Egypt. In response, he announced that the Society would organize

training programs for candidates of Society examinations.[7] The American University of Cairo will offer training programs covering the Society's examination curriculum. The textbooks will be prepared by the Society in line with the learning materials developed by the Association of Chartered Certified Accountants in the United Kingdom. The upgraded textbooks, coupled with quality teaching methodology raise expectations that future professional accountants and auditors will gain exposure to international best practices. The limitations of this initiative are that only a handful of elite members in the Society will receive the quality training prior to entry into the profession. The reality is that most practicing accountants and auditors without Society membership will not have access to the training and will continue to lack appropriate knowledge for supporting high-quality corporate financial reporting. Efforts are needed to address this issue.

D. Setting Accounting and Auditing Standards

20. **Egyptian accounting and auditing standards are developed by the profession, discussed and adopted by a ministerial committee, and issued by ministerial decrees.** In May 1997 the Ministry of Economy and Foreign Trade—renamed the Ministry of Foreign Trade—issued Ministerial Decree 478/1997, establishing the Permanent Committee for Standards of Accounting and Auditing.[8] Although official responsibility for setting accounting and auditing standards rests with the Permanent Committee, the Egyptian Society of Accountants and Auditors in practice has the main responsibility for drafting accounting and auditing standards. The Society's standard-setting committee selects international accounting and auditing standards that are applicable to the Egyptian situation. Once the committee selects an international standard, it is translated into local language and becomes the basis for drafting an Egyptian standard that reflects specific requirements under Egyptian laws and regulations. The draft standard is submitted to the Permanent Committee for discussion, finalization, and adoption. The final version of the standard is transmitted to the Ministry of Foreign Trade for issuance by a ministerial decree. The Ministerial Decree 503/1997 was the first to introduce Egyptian Accounting Standards. By end of May 2002, 22 Egyptian Accounting Standards and 6 Egyptian Standards on Auditing had been issued by ministerial decrees. The 6 Egyptian Standards on Auditing focus only on reporting issues and do not cover other areas of International Standards on Auditing (ISA). The current Egyptian Standards on Auditing only addresses the presentation of the final audit report, which may improve the appearance of the final product without necessarily improving the whole process of auditing. However, preface to the Egyptian auditing standards prescribes that ISA should be followed in the absence of Egyptian auditing standards.

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[7] In the recent past, an insignificant number of candidates have passed the Society's examinations; this is mainly attributed to lack of textbooks and unavailability of review courses. Following are results of recent examinations: (November 2000) 76 candidates sat for the intermediate examination of which 9 passed (11 percent) and 52 candidates sat for the final examination of which 16 passed (30 percent); (May 2001) 53 candidates sat for the intermediate examination of which 11 passed (20 percent) and 44 candidates sat for the final examination of which 18 passed (41 percent).

[8] The Permanent Committee is chaired by the chairman of Capital Market Authority and composed of nine members representing the major accounting associations, the Central Auditing Organization, the Capital Market Authority, the Central Bank of Egypt, and the General Authority of Free Trade and Investment.

E. Ensuring Compliance with Accounting and Auditing Standards

21. **Compliance with accounting and auditing standards is constrained by lack of capacity among those who prepare and audit financial statements and by inadequate regulatory enforcement mechanisms.** Lack of knowledge about the application of accounting standards and the unavailability of implementation guidelines on Egyptian and international standards constrain the preparation of financial statements in compliance with the applicable standards. Existing regulations require that IAS be applied if there are no relevant Egyptian Accounting Standards. However, in practice, the up-to-date IAS are not widely utilized in Egypt because English versions are expensive and Arabic translations are often outdated. Some firms, which employ better-trained auditors, often serve more clients than their capacity permits. Overextending client capacity can result in compromised quality control, which could lead to noncompliance with accounting and auditing standards. No effective regulatory mechanisms exist for imposing sanctions on accountants and auditors who fail to comply. Moreover, legal provisions are vague about the civil or criminal liabilities of parties responsible for supplying misleading or incorrect information in audited financial statements.[9]

22. **The Capital Market Authority reviews annual financial statements presented by listed companies.** The main purpose of the review is to ensure timely filing of financial statements. This review uses a checklist that reinforces reporting and disclosure requirements and that helps monitor compliance with accounting and auditing requirements in preparing financial statements. With regard to compliance, it is the reviewers' task to focus on whether companies and auditors have resorted to accounting manipulations that distort the company's financial condition and operating performance. Reviewers also check whether audit reports that accompany financial statements follow the reporting format prescribed by Egyptian Standards on Auditing.

23. **Recent reviews by the Capital Market Authority reveal that many listed companies have not complied with disclosure requirements, and audit reports frequently were not in compliance with required reporting format.** The Capital Market Authority issued letters that point out occurrences of noncompliance to errant companies and auditors. In response, violators assured the Capital Market Authority that similar violations will not be repeated. Existing regulations specify that if a listed company violates accounting and disclosure requirements, the Capital Market Authority is empowered to request that the company correct and redo financial statements. If the company refuses, the Capital Market Authority can enlist a third party to redo the financial statements and the cost must be borne by the company. Also, the Capital Market Authority can suspend or cancel stock market listings of violators. These extreme measures cannot be taken frequently; moral persuasion is more commonly used, but proven ineffective to enforce standards, rules, and regulations. At present no arrangement exists for imposing fines, penalties, or similar sanctions on the errant companies and auditors of financial statements.

[9] Although there are some legal provisions that mention the liabilities of directors and auditors, these seem to be unclear and, in practice, the accountants and auditors do not face any real liability if they violate the legally established accounting and auditing standards. Egyptian accountants and auditors were never sued for their professional misconduct.

24. **The Cairo and Alexandria Stock Exchange has no power to ensure compliance with financial reporting requirements by the listed companies.** The Stock Exchange has no authority to regulate financial reporting by the listed companies. A small team of well-trained specialists of the Stock Exchange reviews the financial statements of actively traded, listed companies. Lacking the necessary authority for enforcement, the Stock Exchange is powerless to apply penalties for noncompliance or incentives for compliance with financial reporting requirements.

25. **The Central Bank of Egypt relies on bank statutory auditors to ensure compliance with accounting and disclosure requirements.** No mechanism exists at the Central Bank for verifying whether general-purpose bank financial statements comply with accounting and reporting standards. If, in the course of monitoring compliance with prudential regulations and rules, bank examiners identify departures from established accounting requirements, steps are taken to correct such departures. The banking supervision department takes specific measures to enforce the accounting and reporting requirements, including approval of selection of the bank's external auditors; meetings between the auditor and bank supervisors prior to the audit; and subsequent meetings with bank supervisors, representatives of bank management, and the external auditor. The external banking supervision department reports any violations of established standards, rules, regulations, and laws, but the Central Bank does not impose any effective sanctions on auditors who fail to comply with this requirement.

26. **The practices of public accountants and auditors are self-regulated.** Auditors frequently issue financial statements and audit reports without a quality assurance check by another impartial reviewer within the auditing firm. Since auditor performance is not subject to outside review, even major audit firms lack incentives to implement appropriate quality controls. Anecdotal evidence revealed that the client of a major Egyptian audit firm requested a "compilation" of financial statements that they mistakenly thought was an audit opinion. When the client expressed dissatisfaction with the completed work, the auditor charged an additional fee to provide the client with an audit report—but without having conducted any audit procedures. Audit firms have never been subjected to lawsuits that resulted in fines or reprimands by any regulatory body. Many audit firms satisfy client needs by circumventing rules of professional conduct.[10] Therefore, improved quality and credibility will require independent practice reviews.

27. **The process of hiring and firing the auditors influences the quality of audit.** Although shareholders have the authority to appoint, remove, and set levels of auditor remuneration, in practice it is a company's top management that controls these decisions. Indeed, research for this ROSC report did not uncover any instance in which shareholders have rejected proposals by management concerning auditor hiring, firing, and remuneration. This practice exerts considerable pressure on auditors to abide by the wishes of top management. In some cases, external auditors have been fired for challenging financial irregularities for which top management appeared to be responsible.

[10] In the past, accounting scandals were associated with serious financial difficulties in some banks and other corporate entities. In those cases, company directors and officers were sent to prison; but the auditors were neither investigated nor sanctioned by any regulatory or professional body.

III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

28. **The Government and the profession have taken significant steps to close the gap between Egyptian Accounting Standards and International Accounting Standards.** Except for lease accounting, Egyptian Accounting Standards were developed in conformity with the IAS. The legal requirements concerning leases do not recognize finance leases and the application of accounting treatments required under the relevant international standard. Ministerial Decree 503/1997 mandates the use of IAS in the absence of Egyptian Accounting Standards, but actual accounting practice is hampered in this regard by inadequate knowledge of current pronouncements of the International Accounting Standards Board and lack of appropriate implementation guidelines. Although formal accounting standards have significantly improved during the past five years, actual accounting practice needs to be improved for ensuring sound financial reporting in compliance with the established accounting and reporting standards.

29. **Weak enforcement mechanisms permit gaps between official accounting standards and actual practices.** The lack of practical implementation guidelines on requirements under both Egyptian and international accounting standards contributes to the divergence with actual practice. The review of 2001 financial statements of 30 top-listed companies—in addition to interviews with experienced corporate accountants, practicing auditors, finance executives, investment analysts, academics, and regulators—revealed information about some divergences, including the following:

- ***Disclosures*.** Some companies avoid full disclosure of information in the published financial statements, ignoring the disclosure requirements set by the applicable accounting standards.
- ***Statement of changes in equity*.** Contrary to the applicable standard, the financial statements of many companies do not include a statement of changes in equity.
- ***Segment reporting*.** Very few companies comply with all requirements on segment reporting. Where segment information is presented, there is a tendency to avoid disclosure of key information such as revenues and expenses of segments.
- ***Related-party transactions*.** Required disclosures are rarely fully provided. The financial statements of many companies that seem to have related parties, do not disclose information on either the existence of related parties or related-party transactions.
- ***Impairment of assets*.** Egyptian companies do not follow IAS requirements on undertaking impairment tests of tangible and intangible assets on the balance sheet date. In fact, many accountants and auditors in Egypt are not aware of the requirements on impairment tests and related accounting treatments.
- ***Foreign currency exchange gains and losses*.** Some companies do not adhere to the requirement that foreign currency exchange gains and losses arising from balance sheet date revaluations should be shown in the income statement. Some companies show currency exchange gains under a special account in the liability section of the balance sheet. Some companies capitalize the currency exchange

losses as part of fixed assets, even if all the necessary conditions for such capitalization are not met.[11]

- ***Inventory valuation.*** Very few companies follow all the requirements related to measuring and disclosing inventory at the lower figure of either cost or market value. It is common practice to understate the figure for loss due to obsolete and slow-moving inventory.
- ***Consolidated financial statements.*** Many companies do not consolidate all the subsidiaries and special-purpose entities in accordance with the IAS requirements and related standard interpretation. During review of 30 sets of published financial statements, it was found that several companies that should have prepared consolidated financial statements failed to do so.
- ***Assets pledged as securities.*** In many cases it is a practice not to disclose in the financial statements, assets pledged for securing loans.
- ***Leases.*** All finance leases are treated as operating leases although this contradicts IAS; local standards allow this practice because it meets legal requirements regarding leasing.
- ***Risk exposures and loan loss provisions.*** Banks and other lending institutions usually do not present the analysis of risk exposures required under IAS in the financial statements. Inadequate loan loss provisions distort reported profits of financially troubled financial institutions.
- ***Classifications of current assets and current liabilities.*** Egyptian Accounting Standards require presentation of working capital calculations on the face of the balance sheet. To avoid the appearance of negative working capital, some companies resort to incorrect balance-sheet classification of current and noncurrent items.
- ***Financial instruments.*** The requirements in IAS32, *Financial Instruments: Disclosure and Presentation*, and IAS39, *Financial Instruments: Recognition and Measurement* are not fully observed in preparing the financial statements of corporations and financial institutions.
- ***Timeliness of the financial statements.*** Companies are required by law to present their annual financial statements within three months of the fiscal year-end. In addition, listed companies must present their financial statements 45 days after the end of each quarter. However, many companies fail to meet these requirements.
- ***Distorted earnings per share and understated operating costs.*** Company Law and Tax Law grant employees the right to receive extra financial benefits in the year when profit is distributed. Total benefits should not exceed whichever figure is lower—the ten percent of reported profit or annual employee salaries of the company. These payments to employees are not included in the income statement

[11] An actively traded company with significant foreign shareholding, which accounts for about 10 percent of the market capitalization of top 50 listed companies in the Cairo and Alexandria Stock Exchange, capitalized currency exchange losses in 2000 and 2001; the financial statements in each of these two years includes a disclosure note explaining that the capitalization decision was made because "Egyptian pound suffered a devaluation…." The note is silent about meeting some important conditions for capitalization provided in the IASB-issued standard interpretation of the relevant International Accounting Standard. In reality, at that time the Egyptian pound did not suffer severe devaluation, which is a prerequisite of capitalizing currency exchange losses. Moreover, it seems that the other conditions specified in the standard interpretation were not met.

and are required to be shown as distribution of profit after calculation of company's net income. As a result, the earnings per share calculation based on a company's reported net income provides a distorted picture of earnings per share; also, the operating costs shown on the face of the income statement are too low.

- ***Deferred tax.*** In most cases financial statements fail to account for deferred tax. Most companies provide a disclosure note stating that due to the prevailing tax environment, the amount of deferred tax is not practical to measure.
- ***Events after the balance sheet date.*** Companies usually do not disclose information on events after the balance-sheet date. Noncompliance with the relevant Egyptian Accounting Standard can be found even in the case of many companies that present financial statements three to four months after the balance sheet date.

IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

30. **According to the current mandatory requirements, virtually all International Standards on Auditing are applicable in Egypt.** Auditors are required to follow the six local ISA-based standards that relate to the presentation and format of an auditor's report, and any ISA that relate to other aspects of auditing. Since the ISA are not widely available and most of the audit practitioners do not have access to ISA-based audit practice manuals, knowledge deficiencies constrain most auditors from ensuring sound auditing practice. The degree of compliance with applicable auditing standards varies among large and small firms. Although large auditing firms generally have greater capability to provide quality services, compliance with the standards is not always ensured.

31. **Assessments and discussions revealed important concerns regarding the quality of audits of many large- and medium-size enterprises in the country.** Actual auditing practices were assessed through interviews by the ROSC team with a cross section of practicing auditors and representatives of regulatory bodies, and a facilitated discussion group with audit partners representing nine of the largest audit firms in Egypt. Auditors sometimes issue an audit "clean bill of health" report for clients even when there are serious and material issues that should be explained in the report. Under such circumstances, the auditors usually mention these serious and material issues in the long-form report submitted to management, suggesting steps to overcome these problems in the future. Consequently, this practice distorts the picture for users of audited financial statements. Another important issue is the external auditor's concern that tax accounting often takes precedence over sound general-purpose financial reporting. To ensure favorable tax outcomes, the tax partner, the audit partner, and the client work together to select accounting treatments and prepare appropriate disclosures for reporting in the financial statements. This and other practices incompatible with International Federation of Accountants auditing standards and code of ethics must stop if the profession is to gain credibility.

32. **A gap exists between auditing standards and actual auditing practices.** At present, lack of understanding results in noncompliance or partial-compliance with

auditing standards, which is a problem faced by many auditors who are not part of the international accounting firm networks. Following are some actions that would help to ensure compliance with ISA standards:

- Increasing attention to auditor independence;
- Sharing information among auditors who precede and succeed one another with the same client;
- Obtaining external confirmations regarding audited company's receivables, bank balances, and legal opinions;
- Complying with all requirements for audit quality control;
- Applying procedures to discover fraud and error that may result in material misstatements;
- Applying "professional skepticism";
- Applying audit procedures for related parties;
- Seeking evidence that corroborates management representations;
- Working to increase the profession's knowledge and understanding of ISA.

V. PERCEPTION OF THE QUALITY OF FINANCIAL REPORTING

33. **The investor community generally believes that information available in published financial statements is of low quality.** Interviews and discussions with financial analysts, investment advisors, and foreign and local bank representatives revealed serious concerns that weak enforcement mechanisms facilitate noncompliance with established accounting requirements, and that in practice, internationally comparable auditing standards are inadequately applied. External users of corporate financial information generally believe financial reporting to be of low quality. Most external users indicated that they depend mainly on personal contacts in the company to gather information. Representatives of the investment community generally agree that audited financial statements are rarely reliable and free from material misstatement. In response to a question about the need for improving actual accounting practices in selected areas, most of the interviewees identified the following areas: related-party transactions, impairment of assets, pension accounting, segment reporting, and accounting for leases and financial instruments. All the interviewees strongly agreed that financial reporting would depend on implementation of a strong regulatory regime and effective enforcement mechanisms to ensure compliance.

VI. POLICY RECOMMENDATIONS

34. These policy recommendations are based on a review of accounting and auditing practices, and include valuable inputs from stakeholders interviewed by World Bank staff during the ROSC due diligence exercise. It is expected that these policy recommendations will be used as inputs for a country action plan for accountancy reform in Egypt. Specific recommendations are summarized below.

35. **Improve the statutory framework of accounting and auditing.** Take immediate steps to ensure that the legal and regulatory requirements on accounting, auditing, and financial reporting are intended to protect the public interest. This necessitates adoption of a new law taking into consideration the legislative and regulatory shortcomings highlighted in the report.

36. **Establish an accounting and auditing oversight body.** The government may consider establishing a "board" or a "high council" with responsibility for overseeing public interest activities of practicing auditors, quality of education and training of the professional accountants and auditors, and efficiency and effectiveness of the institutional framework in supporting high-quality financial reporting. The oversight body should assess whether the auditing profession is appropriately serving the interests of users of audited financial statements and the general public. The oversight body should publish assessment reports revealing the problems and prospects of the auditing profession. Moreover, the body should advise professional organizations, educational institutions, and statutory regulators on actions to ensure that the education and training, monitoring and enforcement for accounting and auditing standards are consistent with international best practices. This body may consist of representatives of accounting and auditing stakeholders, including the Ministry of Finance, Ministry of Foreign Trade, Capital Market Authority, Central Bank of Egypt, Cairo and Alexandria Stock Exchange, commerce faculty/business school of the leading universities, preparers of financial statements (business community), Egyptian Society of Accountants, and Syndicate of Accountants. The Capital Market Authority has begun to collaborate with the government and other stakeholders and self-regulatory organizations to establish an Accounting and Auditing Oversight Body as mentioned in the draft Accounting Practice Law.

37. **Strengthen enforcement mechanisms.** High-quality financial reporting depends on enforcement. Merely adopting internationally accepted accounting and auditing standards cannot ensure improvements in corporate financial reporting. There are three important links in the enforcement chain, and each must be strengthened. First, company directors, who have legal responsibility for preparing and presenting financial statements, must ensure that the accounting staff properly apply accounting standards. Second, auditors must act independently to provide assurance that financial statements comply with the established standards and portray a true and fair view of an enterprise's financial conditions and results of operations. And third, both self-regulatory organizations and statutory regulatory bodies must implement arrangements for efficient monitoring of regulatory compliance and consistently take action against violators.

38. **Improve monitoring and enforcement capacity of the Capital Market Authority and the Central Bank of Egypt.** The Capital Market Authority should strengthen its capacity to conduct in-depth review of corporate financial statements to determine the extent of compliance with the standards—not only in appearance but also in substance. The Capital Market Authority should make arrangements for joint efforts with the Cairo and Alexandria Stock Exchange to review financial statements for monitoring and enforcement of established accounting and disclosure requirements. The Capital Market Law and related rules should be strengthened so that the Capital Market Authority has comprehensive power to impose administrative sanctions on the company, the

directors, and the auditors—any parties responsible for violations. Similarly, the Central Bank of Egypt should implement a strong monitoring and enforcement mechanism.

39. **Take preventive measures to improve the degree of compliance with accounting requirements.** The Capital Market Authority should strengthen efforts for motivating the top management of listed companies to comply with the accounting and financial reporting standards. Through workshops, top management should be briefed on their responsibilities regarding compliance with standards, and related enforcement policies. The Capital Market Authority should present case studies demonstrating financial reporting strengths and weaknesses in the country. International developments on improving transparency of corporate financial reporting, new dimensions of regulatory regimes affecting accounting and auditing, and the role of transparent financial reporting in attracting both strategic and portfolio foreign investments could also be presented. Moreover, the Egyptian Society of Accountants and Auditors in collaboration with the Syndicate of Accountants should introduce an outreach program for financial executives and accounting staff of business enterprises to disseminate knowledge on current developments in accounting and financial reporting standards and practices. The Capital Market Authority, as a part of its initiative on strengthening corporate governance, has begun a program, including workshops for encouraging compliance with the accounting and auditing standards.[12]

40. **Establish a strong monitoring and enforcement mechanism for improving the quality of audit.** Recently, Presidential Decree 323/2002 created a practitioners committee within the Syndicate to monitor audit quality and practices. However, the new Accounting Practice Law should include provisions specifically focused on a monitoring and enforcement mechanism for ensuring compliance with the applicable auditing standards and code of ethics, not only in appearance but also in substance. Arrangements should be considered for an "Auditing Practice Review Commission" under joint sponsorship of the Ministry of Finance, the Capital Market Authority, and the Central Bank of Egypt. Other regulatory bodies, including the regulator of the insurance industry, could collaborate. The governance structure of the Review Commission must be strong. The governing board of the Review Commission should have power to enforce actions against violators. The governing board should consist of eminent persons, such as senior academics, well-respected business leaders, retired judges and lawyers, retired accounting and auditing professionals, and well-respected retired civil servants. The active or retired professional accountants and auditors should not be majority members of the governing board. . The Review Commission's main function would be to conduct independent practice review of auditors and audit firms. This body should have an efficient and effective mechanism for taking disciplinary actions on a transparent basis against those found responsible for noncompliance with auditing standards and code of professional ethics. Sanctions may include fines, penalties, and suspension or expulsion from the auditing profession.

41. **Establish legal arrangements to issue accounting and auditing standards and implementation guidelines.** The new Accounting Practice Law must address the

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[12] Report on the Observance of Standards and Codes (ROSC) – Corporate Governance module issued on September 2001, http://www.worldbank.org/ifa/Egyptrosc.pdf.

standard-setting arrangements. No dedicated expert groups exist with responsibility for planning, researching, and drafting accounting and auditing standards; and issuing practical implementation guidelines for standardized application of these standards. The new law should provide guidance on setting up two expert groups—one for accounting standards and the other for auditing standards and an auditor code of ethics. If an existing organization is used as the secretariat of these expert groups, this point needs to be recognized in the new law. The expert accounting group should fully adopt the standards and standard interpretations issued by the International Accounting Standards Board—these should be applicable for all public interest companies (listed companies, banks and other financial institutions, and large companies as defined by certain thresholds). The expert accounting group should develop simplified financial reporting standards for the small- and medium-size enterprises. The expert auditing group should fully adopt the standards and code of ethics issued by the International Federation of Accountants. Both expert groups should update the standards and codes on a regular basis, keeping pace with the issuance of revised/new standards and codes by the international bodies. The main responsibility of these expert groups should be the development of practical implementation guidelines on the applicable standards. The new law, as agreed by all stakeholders, might include provisions requiring the standards and codes developed by the expert groups to be discussed and approved by the Permanent Committee for Standards of Accounting and Auditing, and to be issued by ministerial decrees.

42. **Upgrade the licensing procedure.** To become licensed as an auditor, an individual should meet minimum requirements based on IFAC standards. Also, arrangements for licensing audit firms should be developed on the basis of international best practice. The licensing of individual auditors should be changed in compliance with the IFAC guidelines—qualification examination based on the curriculum conforming to the IFAC guideline/standard on professional education, plus practical experience for at least three years with an authorized training provider under the supervision of a licensed auditor. To qualify as an authorized training provider, an individual should be subject to regulation by an auditing services body that has sufficient capacity to expose the trainee-auditors to the practical aspects of all the applicable standards and codes. The authority that issues audit practice licenses should maintain a list—making periodic assessment updates—of the existing and potential authorized practical training providers. This matter has been addressed in the draft law.

43. **Introduce continuing education requirements for the profession.** Continuing education requirements, which will need monitoring and enforcing, should conform to the IFAC guidelines/standards. Training programs should enable practicing auditors and accountants to gain exposure to the practical application of International Accounting Standards, International Standards on Auditing, and IFAC-issued Code of Ethics for Professional Accountants. This matter can be addressed either within the new law or in regulations issued in accordance with provisions of the law.

44. **Improve curriculum and teaching in accounting programs of universities and colleges.** Review and update the accounting curriculum to incorporate international accounting and auditing standards and include practical-oriented teaching at the undergraduate level in higher educational institutions. The ethical dimensions of business

management, corporate finance, accounting, and auditing should be taught with case studies in the undergraduate programs of business schools/commerce faculties. Attention should be given to increasing the critical thinking skills of student accountants. Training-the-trainers program would enhance the teaching capacity of higher educational institutions toward accounting and auditing with international components. Efforts should be made to link this issue with donor-funded projects on improving higher education.