

REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)
Dominican Republic

ACCOUNTING AND AUDITING

December 30, 2004

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Executive Summary

This report provides an assessment of accounting, financial reporting and auditing practices within the corporate sector in the Dominican Republic (DR), using International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA) as benchmarks, and drawing on international experience and good practices in those fields.

The principal objective of this ROSC assessment is to assist the Government in strengthening private sector accounting and auditing practices, and in enhancing financial transparency in the DR's corporate sector. The development objectives these efforts address are improving the investment climate, fostering competitiveness and furthering regional and international economic integration. Moreover, the recommendations arising from the assessment support the Government's efforts to ensure the stability of the financial sector and mitigate the risk of crises. The principal findings of the assessment are summarized hereafter:

The DR has officially adopted International Accounting Standards (IAS, since then incorporated into IFRS), in 1999, which was a good step toward improving the quality of the financial reporting in the corporate sector. ISA were also adopted by the accounting profession at the same time.

The company law as amended 1953 imposes accounting and auditing obligations on numerous companies, most of which small and medium enterprises. Even though in practice compliance with these obligations is widely acknowledged to be low, they still represent additional cost of doing business for those enterprises that comply. Furthermore, an excessive regulatory burden fosters a pattern of non-compliance with the law, which extends to important requirements. Chronic non-compliance by the business community fosters a lack of confidence in the legal and regulatory framework, which restrains local entrepreneurship and discourages foreign investment.

In the financial sector, accounting and auditing are subject to specific laws and regulations that are fairly recent and therefore mostly untested. These include specific accounting norms which at times conflict with IFRS. One example of such norms is the one allowing banks to defer the accounting of part of loan loss provisions over several years (this rule aims to ease the transition towards more stringent provisioning requirements and will be completely phased-out by December 2007). After the banking crisis of 2003, supervision of the financial sector is being strengthened at the moment, with the assistance of international donors. Each of the four regulatory agencies (Banking, Insurance, Pensions and Securities) has its own regulations on external audits.

This report was prepared by a World Bank team (LCOAA) on the basis of the findings from a diagnostic review carried out in Santo Domingo between April and September 2004. The task team was led by Henri Fortin who was assisted by consultants Luis Gomez Nina and Andres Terrero. Jamil Sopher provided assistance with regards to quality review. The task team also received the support of the World Bank Country Management Unit in Santo Domingo and Washington. The review was conducted through a participatory process involving various stakeholders and led by the Government of the Dominican Republic. The ROSC assessment was cleared for publication by the Government on November 10, 2005.

Executive Summary (continued)

Audited corporate financial statements are not required to be published, except for banks, insurance companies, pension funds and a few conglomerates that have financial activities. Virtually no Dominican enterprise (i.e., non-financial company) publishes its financial statements. The overall level of financial transparency in the corporate sector is therefore minimal. The lack of publicly available audited financial statements makes investing and lending activities more difficult, and therefore hinders enterprises' ability to access to medium-to-long-term financing.

The accounting profession has two organizations: ICPARD, which is mandatory and the members of which are the only ones that can issue audit reports; and CODOCON, which is voluntary. So far the two organizations have not cooperated with each other. They receive most of the proceeds from a stamp tax levied on audit reports. Yet these revenues appear to be insufficient to allow them to discharge their oversight functions, especially as membership fees are low and often not collected.

ICPARD is legally vested with accounting and auditing standard-setting powers. Accordingly, it determined that all Dominican enterprises, including small ones, are to apply IFRS when preparing their statutory financial statements. The adoption of international standards is meant to be automatic, and there is neither *ex ante* nor *ex post* review by ICPARD of the application of the international standards in the DR. ICPARD has revised its code of ethics in 2002, but the code still needs further alignment with IFAC's and strengthening, especially with respect to issues of conflict of interest.

The review noted that existing arrangements for the licensing of auditors require a college degree in accounting but do not provide for compulsory, minimum academic course content in accounting and auditing, nor do they include professional examination; moreover, continuing education requirements are not effectively followed. This is detrimental especially to the quality of the audit practice in the country. The absence of quality control of auditors is also a cause of serious concern.

Aside from external auditors, shareholders-appointed *comisarios* have wide responsibilities including overseeing the financial reporting process. The *comisario*'s assigned functions are somewhat ambiguous in that they encompass internal and external control responsibilities. Moreover, contrary to external auditors, *comisarios* are not required to follow any specific set of professional standards in discharging their duties. In practice, the role of the *comisario* is largely redundant with that of external auditors.

The ROSC Accounting & Auditing included the review of a sample of 20 audited financial statements and found an unusually high occurrence of qualified audit reports, along with a number of departures from IFRS that were not mentioned in the audit reports. This tends to corroborate the view expressed by knowledgeable persons interviewed as part of this ROSC's field work that the current level of compliance with accounting standards is inadequate. It also points to a need to strengthen the audit practice.

As is the case in most countries across Latin America, audit committees and similar governance mechanisms are not mandated by law, and they are still infrequent in the DR, where corporate governance is in an incipient stage, which reflects a corporate structure largely influenced by strong family ownership. The law does not require external auditors to attend the shareholders' annual general meeting to answer questions. There is no provision under the law for civil or criminal penalties to deter fraudulent or misleading financial reporting by boards of directors and/or management.

There is only one company listed on the stock exchange at the moment. However, some large corporate groups have a high number of minority shareholders who represent a substantial percentage of the outstanding capital, and there is a relatively high volume of over-the-counter trading for those shares. Corporate groups that are not formally listed are very loosely regulated.

The policy recommendations of the ROSC Accounting & Auditing in the DR are summarized in the tables hereafter. While acknowledging the difficulties involving passing new legislation, the ROSC team's view is that most of the issues discussed above cannot be addressed within the current legal framework and by simply issuing new regulations or amending existing ones. This is particularly true for the Code of Commerce of 1953, which is clearly outdated on a number of provisions. Additionally, introducing a unified system of public oversight for the audit profession, which would involve various regulatory agencies and state entities, requires a specific piece of legislation.

SUMMARY OF RECOMMENDATIONS IN THE ORDER THEY APPEAR IN THE REPORT						
Action	Type (see footnote)	Responsibility	Timing of effective implementation			
			Short-term (within 1 year)	Medium-term (1 to 2 years)	Long-term (2 to 4 years)	
1. Amend the Code of Commerce to alleviate the regulatory burden on SMEs of having to present audited financial statements under IFRS	1*	STP (on behalf of the Government)		x		
2. Require enterprises to file annual audited financial statements with a public registry to be set-up	1, 2 and 3*	STP			x	
3. Establish an oversight body for the audit profession with wide-ranging responsibilities, including standard-setting for both accounting and auditing	1, 2 and 3*	STP, SB, SIPEN, SIS, SIV, DGII, CoA, ICPARD, AOB		x		
4. Introduce a system of professional certification required for awarding the license of statutory auditor	1, 2 and 3*	AOB			x	
5. Strengthen the code of ethics for professional accountants	2 and 3	AOB	x			
6. Harmonize and strengthen academic curricula in the field of accounting and auditing	2 and 3	STP, Universities, AOB, ICPARD			x	
7. Require mandatory partner rotation within audit firms for all audits of public-interest entities	2	AOB	x			
8. Require large corporate groups whose shareholding structure implies a higher degree of accountability to present audited consolidated financial statements.	1*	STP		x		
9. Clarify the function of <i>comisario</i> in the statutes, eliminating any redundancy with the role of the external auditor	1*	STP	x			

1: Recommendations entailing new legislation of amendments to existing laws [*: These recommendations can be addressed through one legislative action]

2: Other policy recommendations (changes of regulations, etc.)

3: Actions aimed at strengthening the institutional and technical capacity of stakeholders (regulators, auditors, etc.)

SUMMARY OF RECOMMENDATIONS IN THE ORDER THEY APPEAR IN THE REPORT (CONTINUED)					
Action	Type (see footnote)	Responsibility	Timing of effective implementation		
			Short-term (within 1 year)	Medium-term (1 to 2 years)	Long-term (2 to 4 years)
10. Require that external auditors be invited to shareholders' AGM in all public interest entities	1*	STP		x	
11. Harmonize regulatory accounting principles for banks, insurance companies and pension funds with IFRS. Conduct a survey of the impact of such harmonization	2 and 3	SB, SIPEN, SIS	x		x
12. Establish training programs for regulators on accounting and auditing and auditing standards, and enforcement of financial reporting requirements	3	SB, SIPEN, SIS, SIV, ICPARD		x	

1: Recommendations entailing new legislation of amendments to existing laws [*: These recommendations can be addressed through one legislative action]

2: Other policy recommendations (changes of regulations, etc.)

3: Actions aimed at strengthening the institutional and technical capacity of stakeholders (regulators, auditors, etc.)

SUMMARY OF RECOMMENDATIONS BY TYPE OF INTERVENTION					
Description of Intervention	Recom. no.	Responsibility	Timing of effective implementation		
			Short-term (within 1 year)	Medium-term (1 to 2 years)	Long-term (2 to 4 years)
A) AMENDMENTS TO EXISTING LAWS					
Amend the Code of Commerce to alleviate the regulatory burden on SMEs involving audited financial statements	1	STP			
Require enterprises to file annual audited financial statements with a public registry	2	STP			
Establish an oversight body for the audit profession with wide-ranging responsibilities, including standard-setting for both accounting and auditing	3	STP, SB, SIPEN, SIS, SIV, DGII, CoA, ICPARD			
Introduce a system of professional certification required for awarding the license of statutory auditor	4				
Require large corporate groups whose shareholding structure implies a higher degree of accountability to present audited consolidated financial statements.	8	STP			
Clarify the function of <i>comisario</i> in the statutes, eliminating any redundancy with the role of the external auditor	9	STP			
Require that external auditors be invited to shareholders' AGM in all public interest entities	10	STP			

SUMMARY OF RECOMMENDATIONS BY TYPE OF INTERVENTION (CONTINUED)					
Description of Intervention	Recom. no.	Responsibility	Timing of effective implementation		
			Short-term (within 1 year)	Medium-term (1 to 2 years)	Long-term (2 to 4 years)
B) POLICY RECOMMENDATIONS					
Establish regulations regarding obligations of specified corporate entities to file their financial statements with the public registry and the functioning of the registry and responsibilities of the registrar	2	STP			
Design the by-laws and regulations of the audit profession's oversight body; amend regulations on external audits to delegate oversight and monitoring of auditors to the AOB	3	STP, SB, SIPEN, SIS, SIV, DGII, CoA, ICPARD			
Design the system of professional certification required for the license of statutory auditor (academic requirements, professional examination, continuing professional education, delegation to professional bodies)	4	AOB, ICPARD			
Revise the current codes of ethics for professional accountants to strengthen and align them with IFACs' code	5	AOB			
Actively support the ongoing consultation between universities and the accounting profession for harmonizing accounting curricula and re-affirm the importance of that process	6	STP, Universities, AOB, ICPARD			
Through regulation, require mandatory partner rotation within audit firms for all audits of public-interest entities	7	AOB			
Amend relevant regulations to harmonize regulatory accounting principles for banks, insurance companies and pension funds with IFRS.	11	SB, SIPEN, SIS (in their respective areas of purview)			

SUMMARY OF RECOMMENDATIONS BY TYPE OF INTERVENTION (CONTINUED)				
	Responsibility	Short-term (within 1 year)	Medium-term (1 to 2 years)	Long-term (2 to 4 years)
C) CAPACITY BUILDING AND OTHER INTERVENTIONS				
Develop manuals of procedures and training courses for personnel at the registry of financial statements and personnel recruited for the registry ^(a)	2	STP		
Develop manuals of procedures for conducting inspections; providing training courses to members of the oversight board on financial reporting and auditing issues ^(a)	3	STP, SB, SIPEN, SIS, SIV, DGII, CoA, ICPARD		
Develop courses and material for the preparation of the professional examination and continuing education	4	AOB, ICPARD		
Develop training material on strengthened the code of ethics for professional accountants and regulators	5	AOB, ICPARD		
Conduct train the trainers sessions for professors in the field of accounting and auditing	6	Universities, AOB, ICPARD		
Conduct a survey of the impact of harmonizing regulatory accounting principles for banks, insurance companies and pension funds with IFRS	11	SB, SIPEN, SIS (in their respective areas of purview)		
Establish training programs for regulators on accounting and auditing standards, and enforcement of financial reporting requirements	12	SB, SIPEN, SIS, SIV, ICPARD		

^(a) This could be done in part through a “fellowship” arrangement with regulators from other jurisdictions as part of twinning agreements.

CURRENCY: DOMINICAN PESO
1 US\$ = 37 RD\$ as of September 30, 2004

MAIN ABBREVIATIONS AND ACRONYMS

AOB	Audit Oversight Board
AFP	pension fund administrator
AGM	annual general meeting
BCRD	Central Bank of the Dominican Republic
BVRD	Stock Exchange of the Dominican Republic
CAFTA	Central American Free Trade Agreement
CoA	Chamber of Accounts
CODOCON	Dominican College of Accountants
CREP	Commission for the Reform of State-owned Enterprises
DGII	Internal Revenue Services
DR	Dominican Republic
FDI	foreign direct investment
FIRST	Financial Sector Reform and Strengthening Initiative
GDP	gross domestic product
IAS	International Accounting Standards
IASB	International Accounting Standards Board
ICPARD	Institute of Authorized Public Accountants of the Dominican Republic
IDB	Inter-American Development Bank
IES	International Education Standards for Professional Accountants
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
ISA	International Standards on Auditing
LMF	Financial and Monetary Law
LMV	Securities Market Law
LSS	Law of the Social Security System
MIF	Multilateral Investment Fund
OECD	Organization for Economic Cooperation and Development
PIE	public-interest entity
ROSC	Report on the Observance of Standards and Codes
SB	Superintendency of Banks
SIPEN	Superintendency of Pensions
SIS	Superintendency of Insurance
SIV	Superintendency of Securities
SME	small and medium enterprise
SOE	state-owned enterprise

I. BACKGROUND

1. The review of accounting and auditing practices in the Dominican Republic (DR) is a part of the World Bank and International Monetary Fund (IMF) joint initiative on Reports on the Observance of Standards and Codes (ROSC). The review focused on the strengths and weaknesses of the accounting and auditing environment in the corporate sector and how they influence the quality of corporate financial reporting. International Financial Reporting Standards (IFRS)¹ and International Standards on Auditing (ISA)² were used as benchmarks for this assessment, which included both statutory requirements and actual practices.

2. **Over the last decade the DR has enjoyed one of the fastest economic growth rates in Latin America, with GDP increasing by 5.9% on average in real terms during the 1990s.** Growth was mainly driven by export-oriented sectors, tourism, and construction. The economic successes of the 1990s period were partly attributable to a series of reforms, including the expansion of free trade zones, the removal of restrictions on foreign direct investment (FDI) and privatization in certain sectors, all of which boosted productivity in the private sector. Besides high levels of FDI, a sustained flow of remittances from Dominican nationals living abroad, especially in the USA, were key growth factors.

3. **However, in 2001, economic growth started declining, and the DR plunged into recession in 2003 after the collapse of the country's third largest commercial bank.** Decreasing external demand and a tourism sector negatively affected by the aftermath of the September 11 terrorist attacks in the USA led to a sharp reduction of real GDP growth, to 3.6% in 2001. The economy recovered somewhat in 2002, to a 4.4% growth of real GDP. Then, in the spring of 2003, a banking crisis erupted with three commercial banks filing for bankruptcy including the country's third largest (Baninter). As a result, real GDP decreased by 1.9% in 2003, and the level of unemployment remains high. In the wake of the Presidential elections of May 2004, which returned former President Fernandez to power, an economic turnaround began, with real GDP growth in 2004 estimated at 2%.

4. **Over the recent years the DR has been actively pursuing economic integration with its regional partners, mainly the USA and Central America.** In August of 2004, the DR adhered to the recently signed Central American Free Trade Agreement (CAFTA) between Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and the USA (which is by far the DR's most important client absorbing 87% of its exports in 2002). The CAFTA agreement has yet to be ratified by both the Dominican and US Congresses.

¹ 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, as well as related official interpretations.

² Issued by the International Auditing and Assurance Standards Board within the International Federation of Accountants (IFAC).

5. **The country's financial sector is dominated by large commercial banks, most of which are controlled by family interests as part of larger, diversified conglomerates, often referred to as financial groups (*grupos financieros*).**³ As of June 2004, 11 commercial banks, including the local branches of two international banks, and 16 development banks (*bancos de desarrollo*) dedicated mostly to small and medium enterprises (SMEs) owned total assets equivalent to US\$8.6 billion.⁴ The insurance sector included 17 insurance companies, down from 24 mostly as a result of the banking crisis, and 2 re-insurers at the end of 2003, with revenues from insurance premiums of RD\$8.4 billion (approximately US\$230 million). As previously noted, the banking sector went through a major crisis in 2003 (see details in Box 1).

Box 1 – The Banking Crisis of 2003

In 2002, *Banco Intercontinental* (“Baninter”), the third largest commercial bank in the DR, started experiencing a wave of withdrawals from depositors. Later, the Central Bank of the Dominican Republic (BCRD) intervened by extending liquidity assistance up to three times the bank's subscribed capital, double the statutory limit of 1½. However, this was not sufficient to restore confidence and, in May 2003, Baninter filed for bankruptcy, a substantial part of its business being acquired by a large Canadian bank. It was then revealed that Baninter had been running a parallel accounting system since 1989 to channel funds, in the form of promissory notes, to off-shore entities under the control of common family interests. The demise of Baninter triggered a domino effect, affecting two mid-sized banking groups, *Banco Nacional de Crédito* and *Banco Mercantil* which were sold respectively to the smaller *Banco Profesional* and its shareholders (in June 2003) and to the Republic Bank of Trinidad and Tobago (in August 2003). Moreover, the negative consequences of the Baninter bankruptcy were felt in the insurance sector, where the three largest companies linked to the above mentioned banks also went bankrupt.

The Baninter crisis and its sequels revealed serious shortcomings in accounting and financial reporting practices (loan loss provisions understated, hidden liabilities, etc.). Moreover, supervision of commercial banks by both the BCRD and the Superintendency of Banks (SB) was found to be inadequate. A Stand-By Arrangement with the IMF provides for the strengthening of the banking sector, including enhanced regulatory supervision. To that effect, financial sector reform is currently under way with the support of the IDB, the IMF and the World Bank, consistent with the objectives set in the Stand-By Arrangement aimed at restoring confidence in the financial sector.

6. **The DR's securities market is in an incipient stage and plays a marginal role in providing long term corporate capital.** The Stock Exchange of the Dominican Republic (*Bolsa de Valores de la República Dominicana* or BVRD) was established in the early 1990s, but so far only short-term, commercial paper has been issued, with little if any secondary market. A new Securities Market Law (*Ley de Mercado de Valores* or LMV)⁵ came into force in 2003, providing a stronger regulatory framework and more transparency to the market. Currently there is only one issuer of securities⁶ officially registered with the recently established Superintendency of Securities (*Superintendencia de Valores* or SIV).

³ As of March 31, 2004, there were three such groups in activity (source: SB). Financial groups also operate insurance and pension fund management activities.

⁴ In addition, there are 13 savings and loan associations, a mortgage bank and a series of smaller financial institutions.

⁵ Law no. 19-00 of May 8, 2000 complemented by the Securities Regulations of March 19, 2002 (Presidential Decree no. 201-02).

⁶ After the LMV was passed in 2000, companies who had previously issued notes, for which no secondary market existed, were no longer considered listed. A company is in the process of being listed as part of an issue of bonds for RD\$ 50 million (details at: www.siv.gov.do/Emisiones.shtml).

7. **The recent introduction of a private pension system is expected to contribute to the development of capital markets in the DR.** The Law of the Social Security System (*Ley del Sistema Dominicano de Seguridad Social* or LSS) of 2001 establishes a private pension fund system subject to regulation by a government agency, the Superintendency of Pensions (*Superintendencia de Pensiones* or SIPEN). The system, which started operating in 2003, takes account of the experience of other Latin American countries, especially Chile's. It provides for a mandatory defined benefit scheme to workers in the private sector, most of the funding coming from employers, with a relatively substantial contribution from the workers themselves. The funds are managed by 9 pension fund administrators (*administrador de fondo de pensión* or AFP) registered with the SIPEN. The funds can be invested only in instruments authorized by the SIPEN, such as bank notes and debt or equity securities. Currently, most funds are invested in fixed income instruments issued by banks. The SIPEN is seeking to facilitate the diversification of AFPs' investments towards instruments issued by corporate entities.⁷ Among their fiduciary responsibilities, AFPs need to be able to properly manage the risks attached to investments in long-term, private securities, and to report adequately on the performance of these investments. This requires access to quality and reliable financial statements from the issuers of those securities. Therefore, financial transparency on the part of companies listed in the DR's securities market appears to be a pre-requisite to the development of the pension system.

8. **DR's rapidly increasing budget deficit represents a major issue for the Government to tackle.** The latest figures point to a consolidated public deficit at 8.1% of GDP in 2003 and 7.2% in 2004, with public sector debt at 53% at the end of 2004. Necessary fiscal adjustments are likely to include an increase in the generation of State revenues, which currently represent 16% of GDP. This will require curtailing tax evasion on corporate profits which is widely acknowledged to be still very significant. Strengthened accounting and auditing practices support that objective, as corporate income tax calculations rely on accounting records, and weak auditing practices facilitate the use of accounting schemes aimed at tax evasion.

9. **The DR's reform agenda also includes state-owned enterprises (SOEs), who play a significant role in the country's economy.** In the mid-1990s, the DR initiated a process of restructuring and reducing the size of the state-owned sector through privatization or disposal of assets. A Commission for the Reform of State-owned Enterprises (*Comisión de Reforma de la Empresa Pública* or CREP) was established to conduct this process. Additionally, a trust was established (*Fondo Patrimonial de Empresas Reformadas*) to manage the proceeds from the dividends paid by SOEs.⁸ Effective financial management of these enterprises—which apply private sector accounting and should be audited by private audit firms—is a condition of the success of the Government's efforts to develop these activities and to prevent losses that would further deepen the budget deficit. It requires good accounting and financial reporting practices on the part of those SOEs and high quality audits.

⁷ Corporate entities refer to enterprises of any size, owned either by the state or by private interests, and that do not belong to the financial sector (e.g., banking, insurance, investment or pension funds, and brokerage firms).

⁸ Several SOEs received capital inflows, including in the sugar, manufacturing, mining, hotels, and airline industry. In the power sector, the state monopoly (*Corporación Dominicana de Electricidad*) was split into generation, transmission and distribution entities and two distribution companies were privatized. Three other holding companies (*Corporación Dominicana de Empresas Estatales*, *Consejo Estatal del Azúcar*, and *Corporación de Fomento de la Industria Hotelera*) were also established.

10. **Strengthening private sector accounting and auditing practices in the DR and aligning them with international standards will help the country address some of the economic challenges it faces at present.** Restoring sustained economic growth at the levels experienced in the 1990s is one of the main priorities of the Dominican authorities. It will require improving the competitiveness of the DR's private sector and increased levels of foreign investment in key sectors of the economy. Areas where improved accounting and auditing practices in the corporate sector are expected to bring long-term benefits for the country include:

- *Improving the investment climate*, by enhancing financial transparency, which requires robust accounting and auditing practices in the private sector. The large amounts of FDI that the DR was able to attract in the past occurred before the banking crisis, which severely damaged confidence. Moreover, these investments were for a large part in the tourism industry where developing projects is probably easier than in other sectors that require stricter governance and financial transparency. Access to reliable financial information is therefore critical to attracting FDI from the major financial centers and to mobilizing domestic savings especially on the part of non-resident citizens.
- *Reducing the risk of financial crises and the associated negative impact on the economy*, since the dependability of the financial reporting by enterprises directly affects the banking sector's ability to assess the quality of their loan portfolio properly.
- *Enhancing enterprises' opportunities to access long-term financing*, either through the stock exchange or borrowings, which requires sound accounting and reporting practices including reliable audits.
- *Supporting the development of privately managed pension funds by widening the range of investments available to these funds* – Increasing the quality and reliability of corporate financial reporting will create opportunities for pension fund managers to diversify their investments into private sector securities, thereby reducing their dependence on the banking sector and offering prospects to increase average returns on investment.
- *Facilitating the DR's economic integration on a regional level*, through the accelerated convergence of standards and practices among the partners within the CAFTA, especially with the USA.
- *Fiscal consolidation* – Since corporate income tax is determined on the basis of the companies' accounts, the ability of the Dominican State to increase its revenues from taxation depends on the quality of applicable accounting standards and on effective compliance by corporate taxpayers with those standards.
- *Improved governance of SOEs* – Enforcing strict financial reporting requirements within SOEs will allow the government and the public to become better informed on the financial position and performance of these enterprises. This will help the government's maximize the value of these assets—including in relation to privatizations or private concessions—and take any corrective actions against the risk of deficits.

11. **Based on the preceding discussion, the strategic objectives this ROSC seeks to address are:**

- (i) ***Strengthening the standards of private sector governance***, to restore confidence in and foster the growth and development of the private sector, which declined in the aftermath of the financial and energy sector crises of 2003, and
- (ii) ***Improving the investment climate for foreign direct investment.***

II. INSTITUTIONAL FRAMEWORK FOR PRIVATE SECTOR ACCOUNTING AND AUDITING

12. **Outdated or inadequate provisions in the law, coupled with a certain pattern of non-compliance with the law, weaken the institutional and legal framework for accounting and auditing.** As further discussed in this Section, Dominican Law has quite stringent accounting and auditing requirements on small- or medium-sized business entities (SMEs), but with no real benefits for society. On the opposite end, requirements on large corporate groups, which have much higher accountability vis-à-vis the public, are relatively light. Moreover, as is the case in many countries of Latin America, there is no tradition of strong enforcement of the laws and regulations in the DR. The consequences of this are, on one hand, large companies are encouraged not to report in a transparent fashion because they are insufficiently regulated and, on the other hand, unnecessary requirements on small-sized entities increases their cost of doing business in the country. In response to the banking crisis of 2003, efforts are being made to strengthen the enforcement regime in the financial sector.

A. Statutory Framework

13. **The Code of Commerce as amended 1953 establishes basic requirements in accounting and auditing for a large number of companies in the Dominican Republic, including small businesses.** Under the Code of Commerce and related legislation, any business entity that is party to a contract of any nature with the Dominican State, for an amount in excess of RD\$50,000 (equivalent to \$1,400 approximately) is required to keep accounting books in a systematic manner.⁹ Such relatively low thresholds in effect lead to imposing bookkeeping obligations on small companies in the DR often without economic justification.

14. **Corporate entities in the DR are legally required to apply the accounting standards issued by the Institute of Authorized Public Accountants of the Dominican Republic (*Instituto de Contadores Públicos Autorizados de la República Dominicana* or ICPARD).** Under Dominican Law,¹⁰ ICPARD is the country's accounting standard-setting body for general purpose financial statements, and has regulatory and standard-setting powers over the accounting profession. As a result of a decision by ICPARD in 1999, IFRS are now mandatory in the DR.¹¹

15. **The law does not explicitly require groups of companies to prepare consolidated financial statements.** Even though IFRS does require consolidation for companies with subsidiaries, because the Code of Commerce does not contain a specific provision dealing the issue of consolidation, it is not clear whether Dominican companies are actually required to prepare consolidated accounts and, if required, whether they comply. This represents a serious shortcoming in the regulatory framework as non-consolidated financials provide incomplete view of a company's financial performance and position. Whenever applicable, the presentation of both consolidated and non-consolidated statements should be mandated by the law.

⁹ Law no. 3531 of April 18, 1953, Article 18. The threshold amount has not been modified since the passing of the law.

¹⁰ Law no. 633 1944 and related Regulations 2032 (Executive decree of June 1, 1984).

¹¹ Further discussion in paragraphs 27 and 36-37.

16. **Dominican law requires a financial statement audit for an unusually high number of corporate entities.** An independent audit of the financial statements is mandatory for companies with a paid capital in excess of RD\$750,000 (equivalent to \$20,000).¹² Although no statistics could be obtained regarding the number of business entities affected by this requirement, such number is believed to be very high and to include numerous SMEs. Independent auditors are permitted, but not required, to attend the shareholders' annual general meeting (AGM) to answer questions; consequently, minority shareholders are not always given the opportunity to obtain clarification from the auditor on issues of concern to them.

17. **In the financial sector, accounting and auditing obligations are set in specific pieces of recently enacted legislation, which mandate the same set of accounting standards for both regulatory and public reporting purposes.** For all matters pertaining to accounting, financial reporting and auditing, banks and other financial institutions must comply with the provisions of the Monetary and Financial Law (*Ley Monetaria y Financiera* or LMF) of 2002¹³ and the related regulations set by the Monetary Board or the Superintendency of Banks (*Superintendencia de Bancos* or SB).¹⁴ These regulations include a compulsory chart of accounts, provide for a template of financial statements, mandate the calendar year as the reporting period and set accounting principles dealing with valuation of assets, recognition of losses on loans, etc.¹⁵ There is no distinction between general-purpose and regulatory financial reporting. Similar situations prevail in the insurance and pension fund sectors, under the Law on Insurance¹⁶ and the LSS and related regulations issued by the Superintendency of Insurance (*Superintendencia de Seguros* or SIS) and the SIPEN, respectively.

18. **Accounting and auditing by the large financial groups are loosely regulated.** Financial groups (paragraph 5) are subject to certain reporting requirements of the SB, and each financial entity within the group (bank, insurance company and AFP) is regulated by the respective Superintendency. But the consolidated activities of the financial group as a whole are not subject to specific supervision, which reduces the regulators' ability to identify weaknesses and risks of instability within these groups.

19. **The securities market's legal framework was thoroughly amended in 2000 and is still going through a transition phase.** As previously noted (paragraph 6), a new Securities Market Law (LMV) was enacted in 2000 and related regulations were issued shortly thereafter. These require all listed companies to file their annual, audited and quarterly, unaudited financial statements with the SIV. These statements must be prepared in accordance with the standards set by the SIV (Securities Regulations, Article 82). For initial public offerings, financial statements for the last three years are required.

20. **The Code of Commerce provides for an additional control mechanism over the accounting and financial reporting, through the mandatory appointment of a *comisario*.** As in a number of other Latin American countries,¹⁷ and similarly to other countries with civil law tradition, Dominican law requires that the shareholders' AGM appoint an individual with broad

¹² Law no. 4548 of September 22, 1956, Article 1.

¹³ Law no. 183-02 of November 21, 2002. "Financial institutions are required to maintain accounting records of all transactions under the chart of accounts and accounting norms issued by the Banking Superintendency following international standards in matters of accounting" (Article 54 a).

¹⁴ Under the LMF, the Monetary Board (*Junta Monetaria*) is the supreme regulatory agency of the banking sector, overseeing the BCRD and SB to which it can delegate some of its functions.

¹⁵ Referred to as "prudential norms". Differences with IFRS are discussed in paragraph 43.

¹⁶ Law no. 146-02 on Insurance and Sureties of September 26, 2002. Article 153 of the law dealing with Accounting includes very basic provisions.

¹⁷ Including Brazil, Chile, Colombia, Ecuador, and Mexico.

oversight responsibilities over the financial reporting. This person is given the title of *comisario de cuentas* (*comisario*). The functions of the *comisario*, to be detailed in the company By-laws, broadly encompass those of an external auditor and an audit committee. They specifically include examining the annual, statutory financial statements. The *comisario* is also to issue a report to the shareholders' AGM containing an opinion on the annual financial statements and requesting that the AGM give a formal endorsement of the decisions of the Chairman and Board of Directors (*Consejo Directivo*) during the fiscal year.¹⁸ Dominican practitioners interviewed expressed the opinion that the function of *comisario* a) represents a broader scope of responsibilities than that of an external auditor, entailing greater professional risk, and b) include responsibilities of both internal and external control that conflict with each other. In practice, to avoid duplication of tasks and because of the greater level of risk attached, the *comisario* relies heavily on the work of the external auditor and, when the latter is an audit firm, the *comisario* is often a partner of the audit firm.

21. **Corporate taxpayers are required to file abridged annual financial statements with the tax authorities together with the external auditor's opinion.** Under law 11-92, companies must file their annual balance sheet, income statement and cash flow statement every year with the Internal Revenue Services (*Dirección General de Impuestos Internos* or DGII), under a standard format ("IR-2"). Attached to the IR-2 is a statement ("Annex F") containing the auditor's opinion on the financial statements (either unqualified, qualified, or disclaimer of opinion). According to the DGII, some 5,000 companies file an IR-2 return each year. A stamp tax is levied on the IR-2 depending on total assets of the company.¹⁹

22. **In the financial sector, each regulator has set its own rules for accountants to qualify as statutory auditors and to perform external audits.** For the banking sector, the Monetary Board's recently issued Regulations on External Auditors are comprehensive and provide a set of detailed requirements on the registration of external auditors, auditor independence, applicable standards, etc. (see summary in Box 2). As for insurance companies, pension funds and listed companies, the regulations of the respective government agency (SIPEN, SIS and SIV) set requirements for the registration of external auditors among other provisions. Each Superintendency keeps its own registry of authorized external auditors, which represents a source of duplication since, in essence, the requirements to qualify as external auditors should be very similar.²⁰

23. **State-owned enterprises must comply with the Code of Commerce in terms of accounting and auditing requirements and are under the purview of the Chamber of Accounts (*Cámara de Cuentas de la República*).** Under a recently enacted Dominican Law, the Chamber of Accounts' prior approval is required for the appointment of independent auditors in any state-owned enterprise (SOE).²¹ The objective of such approval is to rationalize the use of private audit firms within SOEs and the costs attached.

¹⁸ Code of Commerce, Articles 56 to 60.

¹⁹ Executive Decree no. 395-97 of September 11, 1997. RD\$100 is levied for each RD\$10 million of the entity's assets. According to the DGII, some 30 to 40,000 stamps (*sellos*) are sold each year, representing annual proceeds of approximately RD\$50 million. 90% of the proceeds are awarded to the two accounting professional organizations recognized under the Laws of the DR (see paragraphs 27 and 28).

²⁰ As of September 2004, SB, SIPEN and SIV had qualified respectively 67, 11 and 8 audit firms or individual auditors. The list of authorized auditors can be accessed on the website of the respective Superintendency.

²¹ *Ley de Cámara de Cuentas* – Law no. 10-04 of January 8, 2004, Articles 2(6) and 32.

Box 2 – Regulation of External Auditors in the Banking Sector

On August 5, 2004 the Monetary Board issued a Resolution on Regulation of External Auditors to strengthen requirements regarding auditor’s licensing, appointment, procedures and responsibilities.

- **Registration of auditors (Art. 2 to 7)** – In order to be able to conduct statutory audits in banks and other financial institutions, external auditors must be an audit firm legally licensed in the DR and registered with the Superintendency of Banks (SB). SB registration requirements include having partners with a minimum of three years of practice in the banking sector and an absence of economic ties—either in the form of investment, or through the provision of advisory consulting services (including *comisario*) that involve amounts that would impair independence—with the financial institution(s) to be audited. However, Article 4 (e) excludes tax consulting from the services that could possibly impair independence, even though a growing international consensus considers such services (which can directly affect the preparation of financial statements) as incompatible with the function of external auditor.
- **Appointment and termination of auditors (Art. 8 to 14)** – The appointment of external auditors must be notified to SB who can reject it. The audit firm retained must submit an engagement letter by which it commits to provide any information requested by SB including working papers. Engagement partners rotation is mandatory after three years, which is significantly shorter than commonly observed international practices. It entails a potential loss of valuable knowledge by the auditors of the audited bank’s activities, which could have adverse consequences on the quality of the audit.
- **Audits of financial statements (Art. 15 to 25)** – The Regulations provide fairly detailed requirements on the way auditors are expected to conduct their audit within financial institutions. These requirements are in line with ISA and rightly emphasize the importance of internal controls and the use of information technology. Auditors are to issue: (i) their report on the financial statements, in accordance with ISA, in which they are also to “indicate compliance with the provisions and technical requirements of the LMF”; and (ii) an opinion on supplemental information pursuant to the SB’s Manual of Accounts. The Regulations do not explicitly require auditors to issue a management letter (required under ISA) containing suggestions for improvement in accounting procedures and internal controls.
- **Responsibilities and sanctions (Art. 26 to 39)** – Auditors are to disclose to the SB all pertinent information on their audits, including a general description of their work program. If aware of “specific information relating to the possible existence of bad practices that affect the entity”, the auditor must inform the audit committee or other competent committee of the Board (Art. 28). If these fail to inform SB adequately, the auditors’ responsibility is to notify SB. Sanctions against errant auditors range from a reprimand to repealing the registration and notification to the professional body’s disciplinary panel (see paragraph 41); they do not provide for monetary sanctions.

Overall, except for a few areas of improvements noted above, the Regulations provide an adequate basis for strengthening the audit practice in the DR’s banking sector and for the banking regulator to leverage the work of external auditors for its own supervisory purposes.

24. **The law does not require corporate entities' annual financial statements to be made available to the public.** Only financial entities are required to do so, mainly by publishing their statements in local newspapers.²² Virtually no Dominican enterprise (i.e., non-financial company) publishes its financial statements. Most of the banks post their financial statements on their websites. In the past, companies in Santo Domingo used to be required to file their annual accounts with a corporate registry managed by the Chamber of Commerce, but compliance with that obligation was low. In the current circumstances, investors and bankers cannot obtain financial information on companies other than those with whom they directly interact, thereby limiting comparative analyses that are normally necessary for credit assessments and investment decisions. Such lack of transparency and information impedes the development of investing, lending and commercial activities in the private sector. Even in the case of a company currently in the process of being listed on the BVRD (paragraph 6), the offering circular issued on occasion of the listing did not contain the financial statements, contrary to common international practices.²³ Regarding SOEs, little information is available to the public for monitoring their financial situation and performance. This limits SOEs' accountability to the public and entails an increased risk of inadequate management and/or unreported losses; in turn, it represents a financial risk for the DR's budget, as losses of SOEs would likely be absorbed by the State budget.

B. The Accounting Profession

25. **Public accountants as individuals or accounting firms must be licensed by the Dominican Government to operate in the country.** Would-be public accountants must apply for a license (“*exequatur*”) with the Ministry of Finance (*Secretaría de Estado de Finanzas*), and the license is then issued under an Executive Decree. A few international firms have received special Executive Decrees in the past. The licensing process is a mere formality, requiring only that candidates provide evidence of appropriate academic records. These accountants can then use the title of authorized public accountant (*contador público autorizado*). The license can only be repealed by the Government or a Court of Law.

26. **Professional experience is not a pre-requisite for obtaining an auditor license, and neither is passing a professional examination.** The only requirement to apply for the license of public accountant is a college degree in accounting issued by one of the country's universities with an accounting curriculum. This clearly departs from the international best practices as codified by IFAC in its International Education Standards for Professional Accountants (IES) issued since 2003. The consequence is that licenses are often awarded to accountants who have not demonstrated the technical capacity, ethical behavior and professional skills to carry-out audits of adequate quality.

27. **ICPARD is the main professional accounting organization in the country.** ICPARD is a full member of IFAC and of the Inter-American Association of Accountants (a regional body with no standard-setting or regulatory role). Affiliation to the ICPARD is mandatory, although in effect many practitioners are not affiliated. It has a membership of approximately 10,000. As previously noted (paragraph 14), ICPARD is legally empowered with general-purpose accounting and auditing standard-setting in the DR. It is governed by a Board of Directors elected by the

²² Financial groups are required to publish their financial statements quarterly, under a resolution of SB. The published statements are unconsolidated.

²³ Conversely, there are a few cases of non-listed enterprises that publish their financial statements on their website (e.g., *Grupo Popular*, one of the aforementioned financial groups).

membership every two years. It has several working committees²⁴ appointed by the Board, a Disciplinary Panel and a full time Technical Director who coordinates the work of some of the committees. ICPARD is funded by the fee paid by its members, its share in the proceeds of the stamp tax on financial statements, and to a lesser extent revenues from training courses and publications.²⁵ According to the ICPARD leadership, the Institute's current levels of revenue are insufficient to discharge its mission of self-regulation and oversight appropriately. Members of the Institute's working committees contribute their time *pro bono*, which is an inherent limitation to the time they dedicate. It appears that ICPARD has faced severe difficulties in collecting members' dues.

28. **The Dominican College of Accountants (*Colegio Dominicano de Contadores or CODOCON*), a voluntary organization, is the other legally recognized professional accounting organization in the DR.**²⁶ CODOCON was created as a result of disagreements within the profession by accountants who sought to distance themselves from what they perceived as an organization in which large audit firms had undue influence (no specific information was obtained as to the precise nature of those disagreements). At present, CODOCON claims approximately 7,000 members throughout the country. It receives 45% of the revenues derived from the stamp tax.²⁷ In the recent past, there have been initiatives by the leaderships of ICPARD and CODOCON to merge the two organizations, but these attempts have failed due to a lack of support in the respective memberships.

29. **The actual market for auditing services in the DR is relatively small, due to a relatively low demand, and is dominated by a few large audit firms.** Most financial entities as well as the large corporate entities²⁸ are audited by audit firms affiliated to international networks, especially the "Big four". As for SMEs, although under the Law a large number of them are required to be audited (see paragraph 16), practitioners and observers who were interviewed indicated that few of these SMEs actually have their financial statements audited. For those SMEs where audits are carried out, many observers point to excess supply as a factor driving prices downward and negatively affecting the overall quality of those audits. A solution to ensure quality in audits would therefore be to enforce professional standards on licensed public accountants and effective sanctions against practitioners who do not abide by the standards.

30. **ICPARD has a code of ethics for its membership which is comprehensive but not as demanding as IFAC's *Code of Ethics for Professional Accountants (revised 2003)*.** ICPARD's revised code of professional ethics was issued on October 9, 2001 and covers a wide array of issues involving professional conduct.²⁹ On the issue of conflicts-of-interest, ICPARD's code is much less thorough than IFAC's in discussing situations where independence could be impaired

²⁴ These committees deal with various matters including: (i) professional ethics, (ii) continuing professional education, (iii) accounting standards and (iv) auditing standards. ICPARD has also three regional offices (North, South and East) that coordinate its local activities (training, elections, etc.).

²⁵ As previously noted (paragraph 18), 90% of the proceeds from the stamp go to the two legally recognized accounting professional organizations in the DR. This amount is split in equal shares between ICPARD and the other organization.

²⁶ Executive Decree no. 3536 of August 10, 1978.

²⁷ Executive Decree no. 723-01 of July 5, 2001.

²⁸ According to the DGII, there some 700 to 800 large taxpayers ("*grandes contribuyentes*") accounting for approximately 70% of the Dominican State's revenues.

²⁹ The code has 8 main sections dealing with a) relationship with the public, which covers issues of independence, conflicts of interests, and confidentiality, b) relationship with other public accountants, c) relationship with clients, d) the rendering of services, e) retaining a client, f) accountants in government, g) advertising and h) sanctions).

and little guidance is provided for the accountant to identify and assess such situations.³⁰ Sanctions for breaching the provisions of the ethics code range from reprimand to “referral to competent authorities”. CODOCON has its own code of ethics, which dates back to 1984, and is much less comprehensive than ICPARD’s. Considering that members of both organizations are all public accountants, they should have the same ethical obligations vis-à-vis the society.³¹

31. **Professional responsibility insurance is not mandatory for licensed audit firms.** Although insurance companies operating in the DR do offer this type of insurance policy, only largest audit firms, mainly the ones with international affiliation, subscribe such policies. According to practitioners interviewed during the ROSC review, small audit practices and individual auditors are deterred by the high premiums required by local insurers, which re-insure the risk abroad. In addition, audit firms can be incorporated as joint-stock companies (*sociedad anónima*), with no minimum capital requirements, which limits the possibility for claimants to obtain compensation from the partners of the firm, and therefore limits the accountability of auditors.

C. Professional Education and Training

32. **Most universities in the DR offer an accounting curriculum but the quality of these curricula is uneven.** One public and over 30 private universities have accounting curricula in the DR, either for accounting technicians (two years of studies) or for bachelors in accounting (four years). There are no minimum requirements in terms of the type and content of the courses on accounting and auditing provided by the various universities. As a result, the title of public accountant does not reflect the same quality from one university to another, and the license (“*exequatur*”; see paragraph 25) of public accountant may be awarded to individuals who have not been adequately prepared to perform quality audits under ISA. Additionally, this has had detrimental effects on the image of the accounting profession vis-à-vis the business community and Dominican society in general. In the past, the accounting curriculum was much sought after by university students, but the number of accounting students in the most prestigious universities³² has been diminishing in favor of the business administration curricula. In parallel, the number of students in accounting in universities of lesser reputation has been growing, contributing to the excess of supply currently experienced by the profession. The consequence is that the perceived value of a financial audit and related services appears to have diminished in the DR.

33. **An effort is under way since October 2002 to harmonize university accounting curricula in the DR.** Various leading universities along with ICPARD and CODOCON have created a working committee to establish a platform of accounting education and make relatively

³⁰ Of particular concern is the fact that the ICPARD code accepts the possibility for members to conduct other business activities than those of an accountant. Additionally, on the issue of which of services auditors can provide to a client, paragraph 2.1.9 of the code states that “the mere fact that a public accountant simultaneously renders external audit and management consulting services does not imply a breach of independence, as long as these services do not include taking part in the management and financial decision-making process”. The scope and extent of non-audit services that independent auditors may provide should be strictly limited—the language of the code should be amended in that respect.

³¹ Even though public accountants who provide bookkeeping services to companies work for the management, they have obligations toward the society including of not willfully contributing to the erroneous or distorted accounts. As for external auditors, they have the same general ethical obligations and, in addition, they must be independent from the management.

³² Including UNAPEC, UNIBE (*Ibero-Americana*), INTEC and *Pontificia Universidad Católica Madre y Maestra*.

uniform an improved curriculum. The committee works under the aegis of the Ministry of Education, Science and Technology. To date, the committee has reached an agreement on a few aspects including a unified course content for basic education in accounting, and a working group has been set-up to elaborate detailed syllabi for each of those basic courses. Yet, after 2 years, progress has been relatively modest and this process is expected still to take more time, because private universities have legal autonomy in defining their curricula. The successful completion of these efforts to harmonize accounting and auditing education is a pre-condition for strengthening the accounting and auditing practice in the DR.

34. **Continuing professional education is not mandatory under the Law and not required by either of the two accounting organizations in the DR.** ICPARD has a large teaching facility in Santo Domingo. Its Continuing Education Committee elaborates a voluntary training program offered to the membership on a fee basis. At the time of the adoption of IAS (now IFRS) and ISA, ICPARD had organized courses throughout the country to help its membership familiarize itself with the standards, but these initial efforts do not appear to have had a lasting impact. CODOCON offers some training courses especially for members in small practice and professional accountants in business. However, these programs and facilities would have to be significantly strengthened and used more systematically, to support programs of continuing professional education in line with IFAC’s standards and guidelines.

D. Setting General-Purpose Accounting and Auditing Standards

35. **The adoption of international standards in 1999 has significantly alleviated ICPARD’s burden with regards to devising accounting and auditing standards.** Through a resolution dated September 14, 1999, ICPARD adopted the then International Accounting Standards (since then incorporated into IFRS) and International Standards on Auditing (ISA), in lieu of the then-existing eight Bulletins containing “National Standards and Principles”.

36. **Nonetheless, ICPARD must implement important standard-setting functions to ensure a smooth adoption of IFRS and ISA.** Although the original standards in English are set respectively by the IASB and the International Auditing and Assurance Standards Board, an independent standard setting body under the auspices of IFAC, as national accounting and auditing standard-setter ICPARD still retains important responsibilities which are critical to the effective application of the standards. These responsibilities include:

- Actively monitoring and contributing to the process of drafting the original standards (or revisions of the original standards) at IASB and IFAC level;³³
- Translating the standards or, preferably, participating to a process of elaborating a translation within a group of Spanish-speaking country standard-setters;³⁴
- Defining which entities are to apply which standards (e.g., IFRS for large corporate entities; and simplified accounting standards for SMEs—see paragraph 57);
- Making adaptations to the standards as appropriate, for instance by requiring statutory auditors to perform specific, additional procedures or to report on certain events to the shareholders or to regulatory agencies (e.g., in cases of fraud);
- Disseminating these adaptations to the public and reviewing comments received from interested parties; and

³³ Draft IFRSs, or proposed amendments to existing IFRSs or ISAs, are exposed by the IASB for public comment (in English), and the IASB publishes the comments it receives on its website.

³⁴ The Spanish version of IFRS commonly used in the DR is the one published by the Mexican Institute of Public Accountants, which has been officially approved by the IASB.

- Monitoring the dissemination of the standards and related interpretations to the profession and other key stakeholders (university teachers, financial statement users, regulators, etc.), to ensure that the standards are understood and correctly applied once they come into force.

37. **ICPARD’s lack of resources constrains its ability to conduct these standard-setting functions.** What ICPARD should do to adopt international accounting and auditing standards has not been clearly defined. Except for some initial, commendable efforts to disseminate the standards with training courses and written materials,³⁵ ICPARD’s activities to date have been limited in this regard. As a result, few practitioners appear to have a sufficient knowledge of how to apply IFRS or ISA in the DR.

E. Ensuring Compliance with Accounting and Auditing Standards

38. **Although many corporate entities are legally required to present audited financial statements, there is no enforcement agency to ensure that these entities comply with applicable financial reporting standards.** Tax authorities receive financial statements from over 5,000 corporate entities but do not ensure that accounting standards have been properly applied. Financial reporting by large conglomerates on their consolidated financial position, performance and cash flows is not subject to any supervision, since none of those groups are listed on the BVRD stock exchange.

39. **In the banking sector, the SB has extensive powers to enforce accounting rules and financial reporting standards, but it needs to develop processes to be able to achieve an effective enforcement.** As noted previously (Box 1), following the 2003 banking crisis and under an agreement with the IMF, Dominican authorities have undertaken to enhance the SB’s institutional capacity for more effective supervision. In view of that, the SB is currently receiving technical assistance from the Canadian banking supervisor.³⁶ Under the LMF and related regulations,³⁷ the SB can impose penalties against all financial institutions for non-compliance with banking regulations, especially prudential standards on capital adequacy and valuation of assets and liabilities.³⁸ As regards external auditors, banking sector regulations provide for administrative sanctions for non-compliance with auditing standards and other obligations but these are relatively light and may not be sufficient to deter non-compliance.³⁹

40. **Other financial regulatory agencies (SIPEN, SIS and SIV) have wide enforcement powers with regards to accounting and auditing, but the corresponding sanction regimes need strengthening.**

- In the insurance sector, the SIS has an Inspection Department in charge of enforcement. Sanctions against insurance companies for non-compliance with SIS-issued reporting standards and regulations range from 5 to 50 minimum monthly salaries (equivalent to

³⁵ Specifically, a user’s manual was elaborated in 2000 on the basis of the Spanish version of “IAS 1999” and professionals contracted to train instructors within the Institute. In October 2002, ICPARD issued an “IAS Training Manual” for university professors and continuing education instructors.

³⁶ This technical assistance covers several areas including a) supervision of regulated entities in accordance with the Basel Committee for Banking Supervision’s core principles; b) updating banking regulation and standards; c) recruitment of supervisors and related human resources policies; and d) upgrading information technology used for the supervision.

³⁷ Monetary Board’s Regulations on Sanctions issued December 18, 2003 and Regulations on External Auditors.

³⁸ LMF, Articles 66 to 72. Additionally, management and employees within banks are criminally liable under Article 80 for “concealing, altering, falsifying (...) the books and documents of the entity (...)”.

³⁹ See Box 2.

US\$750 to 7,500), which is relatively low; and there are no sanctions against external auditors.

- On the securities market, the SIV has a Department of Supervision and Control with a relatively experienced staff of five, which is currently developing processes for monitoring registrants' compliance with financial reporting obligations. Under Article 112 of the LMV, the SIV can impose fines of up to RD\$1 million (approximately \$27,000) on companies that “provide information on their economic situation (...) that lead to erroneous decisions” or those who do not provide information required by the law under the appropriate form and on a timely basis. No sanctions are provided on errant auditors.
- The pension sector, like the securities market, is still at an early stage of development. Although AFPs can only invest in bank-issued, fixed-income instruments, monitoring, evaluating and reporting on these investments represent important obligations of the AFPs. Sanctions against APFs for non-compliance with these obligations include fines (LSS Article 113) but the LSS is silent on the responsibility of auditors.

In the absence of sanctions provided by the regulations against non-compliance by auditors with ISA and other auditing requirements, the only recourse for regulators in theory is to refer those cases to a Court; however this involves a lengthy process, the outcome of which is uncertain, especially as the law does not specifically address these cases. Therefore, inadequate audits allowing the presentation of misstated accounting information could avoid being sanctioned. This weakens auditors' incentive to discharge their duties fully and effectively, sometimes by challenging the reporting entity and at the risk of losing a client. Ultimately, it undermines the confidence placed by financial statement users in the reliability of these statements.

41. **Neither ICPARD nor CODOCON enforce auditing and ethical standards among their membership.** Attempts have been made in the past to introduce quality control mechanism within ICPARD but these attempts failed due to the opposition of large segments of the membership. Firms affiliated with large international networks are normally subject to the network's quality control policies. Neither ICPARD nor any regulatory agency monitors compliance with these policies. As a result, although there are many cases of non-compliance, sanctions are very rarely applied against auditors. ICPARD itself has not imposed any sanction—even a reprimand—on its members. Such absence of a proper sanctioning system does not foster compliance with standards and quality in the audit practice. It calls for the introduction of independent oversight of the profession.

III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

A. Standards as Designed

42. **Since January 1, 2000, Dominican enterprises must apply International Financial Reporting Standards (IFRS) when preparing their statutory financial statements.** As already noted (paragraph 35), an ICPARD resolution dated September 14, 1999 mandated international standards in lieu of all previous National Standards and Principles. Therefore, comparability of national standards and IFRS is not an issue in the DR as far as the corporate (i.e. non-financial) sector is concerned. This does not apply however to the financial sector, where specific rules are issued by the respective regulatory agency (SB, SIPEN and SIS).

43. **Accounting standards to be applied by banks for both general-purpose and regulatory financial reporting differ significantly from IFRS.** As of December 31, 2003, the main areas of discrepancy included:⁴⁰

- **Loan loss provisioning** – The main difference with IAS 39, *Financial Instruments: Recognition and Measurement* involves the calculation of provisions⁴¹ but more importantly the way the provisions are recognized in the financial statements. In January 2001, the Monetary Board introduced revised Banking Norms for Evaluating Assets, including a new method for banks to compute provisions. The amount of losses calculated as of June 30, 2001 according to the new method significantly exceeded the values on their balance sheets. Later on, in 2002, commercial banks were given the possibility to recognize the losses over a period 6 years under a straight-line method.⁴² This practice (referred to as “gradualism”) has been observed in other Latin American countries, and is meant to facilitate commercial banks’ compliance with capital adequacy ratio requirement. Nonetheless, it clearly conflicts with the financial statements’ objective of providing a true and fair view of the banks’ financial position, and the concept of deferral losses is unequivocally rejected by IFRS and by any internationally recognized accounting principles. Allowing provisions for losses to be deferred implies that the financial statements do not show the real situation of the bank. In such cases, shareholders together with other interested third parties may be left unaware of the magnitude of losses that need to be absorbed and the corresponding re-capitalization involved. **According to current banking regulations this practice will be completely phased out by 2007.**

The issue of inadequate accounting of loan losses was a factor leading to the recent banking crisis, and addressing this issue adequately is a condition to restoring confidence in the DR’s economy. It is all the more critical when considering that some of the largest corporate groups in the DR conduct significant banking activities.

Accordingly, for general-purpose financial reporting, banks should be required to record any necessary provisions on loans as of the date these provisions are identified and measured and the current practice should be phased out as soon as possible.⁴³

⁴⁰ In certain Dominican banks’ financial statements as of December 31, 2003, some of these differences are explicitly disclosed in the notes on accounting policies.

⁴¹ The compulsory method for computing loan loss provisions is provided in the Banking Norms for Evaluating Assets within Financial Institutions as updated January 9, 2001 (access at: www.supbanco.gov.do/normas/normativas/bancarias.htm). Under the Norms, banks must classify each loan according to the behavior of the debtor and an assessment of its ability to repay the loan (e.g., for corporate loans, from “standard risk” to “loan to be written off”). Provisions are then computed according to provisioning rates estimated by the bank itself or provided in the Banking Norms for each category of loan. This method is based on the Basel Committee core principles, which differ from the requirements of IAS 39. Knowledgeable persons interviewed as part of the ROSC review in the DR expressed the view that the method applied in the DR is conservative.

⁴² Monetary Board Resolution issued December 23, 2002.

⁴³ The Monetary Board has passed several resolutions in December 2004 on loan loss provisions as follows:

- The full amount of provision resulting from the previous, less strict Banking Norm of January 2001 must be recorded as of December 31, 2004 (2nd Resolution of December 15).
- A new Banking Norm for evaluating loan loss provisions was established, setting more stringent conditions for allocating the loans to each of the five categories, therefore leading to an increase in the amount of provision required (1st Resolution of December 29).
- Banks are allowed to record the incremental amount of provision resulting from the revised Banking Norm gradually over the 2005-2007 period (2nd Resolution of December 29).

- **Valuation of investments** – Under the Banking Norms, investments are carried at the lower of cost and realizable value, which means that unrealized profits on any type of investment cannot be recognized. This conflicts with IFRS, which require investments to be valued under different methods according to the characteristics of the investment.⁴⁴ Such rule could have adverse effects on the development the Dominican stock market, as it might represent a disincentive for banks to invest in equity securities if they are not able to report it under a method that is internationally recognized and reflects the real value of the asset.
- **Valuation of property received as collateral on loans** – According to the Banking Norms, such property must be depreciated starting 120 days from the date of transfer and written-off by half after 2 years and fully after 3 years. Under IAS 40, *Investment Property* this type of asset can be valued at fair value and provisions are only required when the fair value is lower than the carrying amount.
- **Deferred charges** – The Banking Norms allow the capitalization of re-organization and similar costs, under certain conditions. This is in direct contradiction with IAS 38, *Intangible Assets*, which requires that they be treated as period expenses as soon as they are incurred. Even if re-organizations are beneficial to the company, such “soft assets” are generally not recognized by investors and lenders and recognizing them can only damage confidence in the reliability of the financial statements. [Note: As a result of SB Circular no. 006/05 issued March 10, 2005, effective as of that date, banks are no longer allowed to capitalize costs that do not meet the conditions set in IFRS. Costs capitalized prior to that date continue to be accounted under the original amortization plan.]

These deviations make it more difficult for international investors to rely on the financial statements of banks (and of the groups that control banks) and do not foster confidence in the financial information and a favorable climate for foreign investment.

44. **Certain statutory accounting rules in the insurance sector also depart from IFRS on important aspects.** These statutory rules include: (a) the measurement of unearned insurance premiums which must be based on compulsory, LSS-prescribed percentages and not on a straight-line basis according to the time elapsed v. the length of the policy⁴⁵; (b) the recognition of income and expense relating to ordinary activities directly through retained earnings when they correspond to transactions that occurred in prior periods (this is permitted under IAS 8, *Net Profit and Loss for the Period (...)* in a more limited number of instances); and (c) insurance and re-insurance companies are required to present a statement of changes of financial position instead of a cash flow statement. Due to these differences, insurance companies cannot claim that they follow IFRS; this tends to reduce the level of confidence international investors or domestic users are likely to place in these statements.

⁴⁴ The three methods are: (i) the equity method, when the investor is able to exercise significant influence over the investee; (ii) amortized cost, mostly for fixed income securities provided they meet certain characteristics; and (iii) fair value, for the remainder. As per IAS 39, paragraph 70 “there is presumption that fair value can be reliably determined for financial assets (...), [which] can be overcome for an investment in an equity security (...).” Given the fact that there is no active trading on the DR’s stock market at present, the difference between the existing rule and the international standard may not have a major impact at present. The rationale for not permitting the systematic application of fair value method to variable-income securities in the DR is apparently that there is no liquid market in the DR and therefore no reliable measurement of fair value. However, even under the accounting rule currently applicable, an estimate of the fair value is needed to be able to evaluate the risk of losses on the investment.

⁴⁵ LSS, Article 141.

B. Actual Reporting Practices

45. **As is relatively commonplace in many countries, tax rules tend to influence the preparation of financial reports, often to the detriment of a fair presentation of the financial information.** Companies often opt to record transactions in their books of accounts following tax rules, which may not be in accordance with accounting standards. This typically applies, for instance, to the valuation of inventories and the computation of depreciation expenses. Moreover, when tax rules do not permit the deductibility of certain accruals or provisions, this creates a major disincentive for companies to account for the corresponding costs. For instance, this happens frequently with employee benefits as, under the Dominican tax code, these benefits can only be counted as cost when disbursed; therefore the required provisions under IFRS are not accepted for tax purposes. The consequence of undue influence of tax rules on the preparation of company financial statements is that the latter do not always reflect the economic reality of these companies and may therefore not be reliable for investors and other third-party users.

46. **The review of a sample of audited financial statements issued by enterprises in the DR evidenced a number of departures from IFRS and at times raised serious questions on the reliability of these financial statements.**⁴⁶ 12 sets of statutory financial statements of non-financial, corporate entities as of December 31, 2003, together with the auditor's report, were obtained and reviewed by the ROSC team.⁴⁷ The main problems arising from the review are summarized hereafter:

- ***A significant number of the audit reports contained a qualified opinion, indicating that the financial statements could contain material errors***⁴⁸ – Qualified audit reports send a negative signal to investors and lenders and may even trigger tax assessments or regulatory agency interventions. They tend to be relatively infrequent in countries with strong enforcement regimes as companies prefer to adjust their accounts rather than being exposed to the negative consequences of having a qualified audit report. Such frequent occurrence of qualified audits also points to a low level of enforcement of enterprises' financial reporting obligations in the DR, and to the need for a more robust enforcement.
- ***The form and presentation of the financial statements (IAS 1)*** – The review noted a number of instances of non-compliance with IAS 1, *Presentation of Financial Statements* some of which are such that they could seriously impair the ability to use the financial statements. This is the case, for instance, with the absence of prior period information (either in financial statements or in the accompanying notes), which was noted for two companies including a very important one, and which is key to understanding the performance of the reporting entity as well as the evolution of its financial position.⁴⁹ Additionally, certain elements of the financial statements, including financial instruments, provisions, intangible assets, accounts receivable or payable were not shown on the face of balance sheet. Also, two companies did not present the required statement of changes in shareholder's equity.

⁴⁶ *International Financial Reporting Standards 2003.*

⁴⁷ The review consisted in reading the financial statements and the auditor's report. It was not meant to identify departures from recognition and measurement requirements and is unlikely to have identified them, if any. Even departures from presentation and disclosure requirements might not be identified.

⁴⁸ Under ISA 700, *The Auditor's Report on Financial Statements*, qualifications correspond broadly to two types of situations: (i) when the auditor concludes that an accounting treatment of a transaction departs from applicable accounting standards, and (ii) when the auditor was unable to perform certain audit procedures necessary for the purpose of expressing an opinion (also referred to as "scope limitation").

⁴⁹ According to IAS 1 (revised 2001), "users must be able to compare the financial statements of an enterprise through time to identify trends in its financial position and performance" (paragraph 39).

- ***Insufficient disclosure of accounting policies (IAS 1)*** – The notes to the financial statements did not always include the required disclosures, especially regarding (a) revenue recognition, (b) employee benefits, (c) useful lives of property, plant and equipment, (d) leases, and (e) the determination of the fair value of financial instruments. Clarity and precision in disclosure of accounting policies is needed for understanding of the financial statements.
- ***Income taxes (IAS 12)*** – One company had recognized a revaluation of its property for a very significant amount, without recognizing the corresponding deferred income tax liability as required under IAS 12. As a result, the equity of that company appears to have been over-stated by approximately 10%. Moreover, the reconciliation between statutory and effective taxation rates is rarely provided. Finally, in another case, the financial statements indicate that a deferred tax asset has been recognized, but no justification is provided on how such asset has been determined and how it is expected to be recovered given the losses the company reported in both 2002 and 2003.
- ***Incomplete related party disclosures (IAS 24)*** – A few companies presented no information at all on related party relationships and transactions. Others omitted important disclosures such as the nature of the relationship and/or transactions, pricing policies, the volumes of related party transactions and the corresponding amounts. Adequate disclosure of material related-party relationships and transactions is essential not only to users' understanding of a company financial position and results, for minority investors' confidence that they will receive a fair treatment.
- ***Absence of provisions and insufficient information on contingencies (IAS 37)*** – In several cases, there were no provisions for certain mandatory employee benefits such as vacation pay and similar obligations. Additionally, in a set of financial statements, the notes mentioned a contingent liability but no estimate of the financial effect of the contingent liability.
- ***Operating expenses unduly capitalized (IAS 38)*** – In five cases, it was apparent from the notes to the financial statements that operating expenses (start-up, reorganization, or advertising) had been capitalized, though under IAS 38, *Intangible Assets*, these should have been expensed as incurred. While the amounts involved were not necessarily material, such accounting practice in direct contradiction with applicable accounting principles is detrimental to the reader's confidence in the reliability of the financial statements.
- ***Financial Instruments (IASs 32 and 39)*** – In three instances, the notes on accounting policies indicated that investments in equity securities were carried at cost; under IAS 39 they should have been stated at fair value. Furthermore, very few companies disclosed information on their exposure to interest rate, credit and foreign exchange risk. Considering the significant fluctuations of the RD\$ against the US\$ that have been observed over the recent years, which affect the operations of many enterprises in the DR, this information is particularly important to users of the financial statement. Incomplete information on such sensitive issues leads to an increased perception of uncertainty on the part of investors and lenders.
- ***Other*** – The review also noted the following: (a) in a number of instance, no explanation or details were provided for significant balances or income statement elements; (b) none of the financial statements mentioned the date when they had been authorized for issue; (c) in three cases, the required information on the characteristics of operating leases were not disclosed; (d) a company did not report its earnings-per-share although under IAS 33 it was required to do so; and (e) one financial group published consolidated financial statements using as reporting basis a combination of IFRS (for non-financial activities)

and regulatory accounting principles (for banking, insurance and pension management); good practices normally require reporting entities to apply a homogeneous set of accounting standards for all their activities.

The audit qualifications and departures from IFRS discussed above are detrimental to the quality—actual or perceived—of the financial reporting and therefore to investors' and lenders' confidence. These deficiencies contribute to inhibit foreign investment in, and lending to, the DR's corporate sector, and can lead to a higher cost of corporate capital in the DR. They point to a need to strengthen the financial reporting process, as well as the audit practice. To attract new investments in the corporate sector and to develop the securities market both in terms of number of BVRD listings and levels of trading, the financial transparency of Dominican companies needs to be improved.

IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

47. **International Standards on Auditing (ISA) are compulsory for all financial statement audits in all companies in the DR.** Since the official adoption of ISA in 1999, all previous ICPARD-issued technical bulletins have been withdrawn.

48. **The environment within which financial statements audits are carried-out in the DR is not conducive to strict compliance with ISA.** Systemic weaknesses that create difficulties or disincentives in complying with ISA include:

- ***The process for adopting and disseminating international standards is hampered by a lack of resources*** (paragraph 37).
- ***Practical experience and technical expertise for applying ISA and enforcing IFRS is still relatively limited*** – This arises from accounting and auditing university curricula not geared toward issues involving the application of IFRS or the use of ISA, and from the absence of mandatory continuing professional education.
- ***Governance structure of Dominican companies*** – Audit committees are not compulsory in the DR, and appear to be infrequently established. However, their role is considered important for ensuring that external auditors fulfill their responsibilities to deliver an audit that meets the needs of the stakeholders.
- ***Company financial statements are not published*** – Therefore non-observance of accounting and auditing standards by companies and auditors respectively are unlikely to be detected by third parties; in turn, practitioners have little incentive to ensure that their clients abide by their financial reporting obligations.
- ***Lack of monitoring and effective sanctions*** – As previously noted, there is no monitoring of the compliance with auditing standards to ensure *inter alia* that practicing auditors in the DR adhere to strict quality assurance procedures. Moreover, the statutes do not explicitly establish civil or criminal sanctions against errant auditors, and sanctions are rarely imposed. **Effectively aligning auditing practices in the DR with international standards will require the introduction of a strong enforcement mechanism for the audit profession.**

49. **Most of the cases of non-compliance with IFRS noted through the ROSC review of audited financial statements were not revealed in the corresponding auditors' reports. This calls for improvements in audit practice.** Some of the departures identified, especially where accounting treatments conflicted directly with explicit provisions of IFRS, should have given rise to qualifications in addition to those already noted in the audit reports. Moreover, in several instances the ROSC review noted issues involving the way the qualifications made by the auditors were worded, which were not fully in accordance with ISA.⁵⁰ The review also noted that the wording of audit report did not always strictly adhere to ISA 700. Furthermore, the generic expressions “generally accepted accounting principles” and “generally accepted auditing standards”, which were used before the adoption of international standards, were sometimes used in the reports, instead of IFRS and ISA respectively. This further evidences the fact that a number of auditors are not currently up to date with international standards, and calls into question whether their audits actually follow international standards.

V. PERCEPTIONS ON THE QUALITY OF FINANCIAL REPORTING

50. **Stakeholders expressed concern about the lack of availability and reliability of the financial reporting in the DR. Those interviewed call for greater regulatory oversight and enforcement of accounting and auditing standards.** A number of financial statement users interviewed as part of the ROSC assessment shared the view that, despite the adoption of IAS (now IFRS), the overall quality of the financial reporting was still unsatisfactory. Stakeholders pointed to the following specific issues of concern and systemic weaknesses:

- Corporate sector's reluctance to provide transparent financial information, mostly for fear of tax consequences;
- Insufficient regulation of financial groups and of off-shore activities, believed by many to be a key factor in the banking crisis of 2003;
- Absence of a proper certification process for auditors; and
- Lack of accountability of external auditors.

On the latter issue, the perceptions of the quality of the audit practice are mixed; many financial statements users interviewed make a clear distinction between the larger audit firms with international affiliation (including the members of the Big-4 networks), from which quality audits are expected, and small firms and sole practitioners in whom they generally do not place the same level of confidence. Nonetheless, the questions raised on the role of auditors in the banks that failed in 2003 has somewhat blurred this perception. Overall, the above mentioned concerns with regard to the reliability of financial information increased the perceived risk in investing or lending in the DR, and therefore contribute to impede Dominican enterprises' access to medium-to-long-term capital and to increase their cost of financing.

⁵⁰ In one case, the auditor objected to the use of the cash basis of accounting for the preparation of the financial statements and stated that the financial position and results of the company at the end of 2003 were higher than reported. However, the audit report did not provide a compelling argument for using the accrual basis in light of the characteristics of the company; and according to the audit report the impact of the corresponding adjustment on the company 2003 earnings is equal to the full, accumulated effect, which seems extremely unlikely.

VI. FINDINGS AND RECOMMENDATIONS

A. Principal Findings

51. The adoption by the DR of international standards (IFRS and ISA) was a good step toward strengthening accounting and auditing practices. However, systemic weaknesses in the regulatory regime, capacity issues, and a pattern of non-compliance with the law hinder the effective application of the standards. The main observations arising from the ROSC Accounting & Auditing assessment in the DR follow:

- (i) The Code of Commerce, which was last amended in 1953, mandates bookkeeping, financial reporting and external audit obligations on companies above a certain size. However, because the thresholds in the law have not been updated according to inflation, at present these obligations extend to numerous SMEs. Even though in practice compliance with these obligations is widely acknowledged to be low, they still represent an important additional cost of doing business for those SMEs that do not comply with the Law. Furthermore, an excessive regulatory burden fosters a pattern of non-compliance with the law, which extends to important requirements.
- (ii) Audited corporate financial statements are not required to be published, except for banks, insurance companies, pension funds and a few “financial groups” (groups of companies with diversified activities including in the financial sector). As a result, virtually no Dominican enterprise (i.e., non-financial company) publishes its financial statements. The overall level of financial transparency in the private sector is therefore minimal. This makes investing and lending activities more difficult, and therefore hinders enterprises’ access to medium-to-long-term financing.
- (iii) In the financial sector, accounting and auditing is subject to specific laws and regulations that are fairly recent and mostly untested. These include specific accounting norms that at times conflict with IFRS. In the banking sector, accounting norms have been amended in December 2004 to introduce a more stringent method for evaluating loan loss provisions (see paragraph 43), and banks have been required to increase the amount of loan loss provisions to match the amount resulting from the previous method of evaluation (Banking Norm of January 2001). Nonetheless, the accounting norms still provide for a method that largely relies on arbitrary parameters, and these norms still allow banks to gradually record the incremental amount of provision (over the 2005-2007 period). Therefore, they still significantly depart from IFRS. In the aftermath of the banking crisis of 2003, state supervision of the financial sector is in the process of being strengthened, with the assistance of international donors. Each of the four Superintendencies (Banking, Insurance, Pensions and Securities) has its own set of regulations on external audits and their own registries of authorized external auditors.
- (iv) The accounting profession is divided between two organizations: ICPARD, with which affiliation is mandatory under the law—although a large number are effectively not affiliated; and CODOCON, a voluntary organization. Only members of ICPARD are allowed to issue audit reports. The two organizations do not cooperate with each other. They lack financial resources as membership fees are low and often not collected. Neither monitors the quality of practice among their membership.
- (v) A stamp tax is levied on company audit reports, on the basis of the total assets of the company. Most of the proceeds from the tax go to the two professional organizations.

- (vi) There are no professional examination and/or professional experience requirements to become a practicing auditor in the DR. The only substantive requirement is a university degree at bachelor level, which is insufficient to ensure that would-be practitioners have adequate knowledge and skills to perform quality audits.
- (vii) ICPARD is legally vested with accounting and auditing standard-setting powers. In 1999, it formally adopted IFRS and ISA. Accordingly, all Dominican enterprises, including small ones, are to apply IFRS when preparing their statutory financial statements. The adoption of international standards is supposed to be automatic, and there is neither *ex ante* nor *ex post* review by ICPARD of the application of the international standards in the DR.
- (viii) ICPARD revised its code of ethics in 2002, but the code still needs further alignment with IFAC's and strengthening especially on issues of conflict of interest. CODOCON's code is much weaker.
- (ix) Many universities in the DR provide education in accounting and auditing; but there is no compulsory minimum course content for these curricula. As a consequence, the quality of accounting education is inconsistent at best.
- (x) There is only one company listed on the BVRD at the moment. Some large corporate groups have a high number of minority shareholders who own a substantial percentage of the outstanding capital on aggregate, and there is a relatively high volume of over-the-counter trading for those shares. Yet those corporate groups that are not formally listed are very loosely regulated.
- (xi) Aside from the external auditors, a *comisario* is to be appointed by the shareholders' annual general meeting with wide responsibilities including over the financial reporting process. The *comisario*'s assigned functions are somewhat ambiguous in that they encompass internal and external control responsibilities. Moreover, contrary to external auditors, *comisarios* do not discharge their duties applying any specific set of professional standards. In practice, the role of the *comisario* is largely redundant with that of external auditors.
- (xii) The review of a sample of audited financial statements of enterprises noted an unusually high occurrence of qualified audit reports, along with a number of departures from IFRS that were not mentioned in the audit reports. This tends to corroborate the view expressed by knowledgeable persons interviewed as part of this ROSC that the current level of compliance with accounting standards is inadequate. It also points to the need to strengthen the audit practice.
- (xiii) As is the case in most countries across Latin America, audit committees and similar governance mechanisms are not mandated by law, and they are still infrequent in the DR. This reflects a corporate structure largely influenced by strong family ownership.
- (xiv) The law does not require external auditors to attend the shareholders' annual general meeting to answer questions.
- (xv) There is no explicit provision under the law for civil or criminal penalties to deter fraudulent or misleading financial reporting by boards of directors and/or management.

Taken as a whole, these findings reflect weaknesses in the DR's accounting and auditing regulatory framework, which undermine the strategic objectives set out in paragraph 11 above. Since most of these weaknesses are embedded in existing laws, the improvements needed to create the desirable level of financial transparency and governance in the private sector will require passing new legislation.

B. Policy Recommendations

52. **The main objective of this ROSC assessment in the DR is to assist the Government in its efforts to strengthen accounting and auditing practices and enhance financial transparency in the corporate sector.** The main development objectives these efforts address are improving the investment climate for FDI and fostering competitiveness. Moreover, the recommendations arising from the ROSC assessment of current accounting and auditing practices in the DR support the Government's efforts to ensure the stability of the financial sector and mitigate the risk of crises. The policy recommendations will be presented to the country stakeholders at a workshop in Santo Domingo. Inputs from the stakeholders will be incorporated into a country action plan that will be developed under the supervision of the Dominican Government, with the assistance of the World Bank and other donors including the Multilateral Investment Fund (MIF).⁵¹ The recommendations are summarized below.

53. **Addressing weaknesses in the current legal and regulatory framework for private sector accounting and auditing will require the passing of a new law.** The legislative process is long and complex. The needed changes in the law—particularly the Code of Commerce of 1953—will require the close involvement of the executive branch. Nonetheless, the scope of the changes needed to adapt accounting and auditing requirements to the needs of the Dominican economy is such that attempting to implement them through regulations will be impractical. Additionally, introducing a unified system of public oversight for the audit profession, which involves various regulatory agencies and state entities, normally requires specific legislation. The changes contemplated could be carried through one legislative action involving a set of amendments to the Code of Commerce and the financial sector laws (LMF, LMV, LSS, and SPP).

54. **Alleviate the regulatory burden on SMEs of having to present audited financial statements under IFRS [amendment to the Code of Commerce].** The independent financial statement audit obligation should only be imposed on enterprises with higher levels of accountability towards the public, including listed companies and large companies that are important to the national economy. The recommended simplification would eliminate an impractical, unenforceable and counterproductive rule. It could be achieved by passing an amendment to the Code of Commerce that would increase the current threshold, above which companies must present audited financial statements, from its current level of RD\$750,000. The increased threshold amount should be defined after thorough consultation with the private sector, banks, the accounting profession and other stakeholders. Furthermore, there is a need for a simplified accounting and financial reporting framework for SMEs, setting requirements commensurate with their size, types of transactions, and more limited range of stakeholders.⁵² A simplified set of standards will make it easier for SMEs to improve the quality of their financial information and, ultimately, to use that information to access credit.

⁵¹ The MIF is a multi-donor trust fund managed by the Inter-American Development Bank (IDB).

⁵² The IASB has initiated in 2003 a project to issue financial reporting standards for reporting by SMEs, which is still under way. Such simplified standards would require a lesser level of disclosure, favor the historical cost measurement basis, and eliminate the most complex options provided in IFRS, especially those requiring the use of fair values. The Dominican standard-setter should closely monitor and participate in this process.

55. **Require large enterprises to file their annual audited financial statements with a public registry, to be set-up by the authorities [amendment to the Code of Commerce].** Requiring large enterprises and other public-interest entities (PIEs⁵³) to publish their financial statements is a key element of their social responsibility, which should reflect their economic impact, not just the fact that their shares are listed on the stock market. Since under the Code of Commerce of 1953, these companies are already required to present audited financial statements annually, introducing this filing requirement in the Law in effect would be a minimal imposition of efforts and cost on these companies. Conversely, absent such publication, the benefits of requiring companies to adhere to a set of financial reporting standards of such quality as IFRS, and to have their financial statements audited, are limited and do not appear to justify the corresponding costs. Besides serving as the depository of company financial statements, the registry would review their basic compliance with the law, in terms of completeness and form. The registry would have legal authority to deny registration in case of incomplete statements, and to levy fines for late submission. Any interested party, including authorities, lenders, suppliers, employees and potential investors, would be able to request a copy of the financial statements for a limited fee. This would bolster financial transparency in the corporate sector and broaden access to financial information by investors and lenders. Considering (a) the important cultural change that publishing financial statements represents and (b) the resources to be deployed to set-up the mechanisms for filing and publishing financial statements, sufficient time should be accommodated for the transition from the current arrangements toward the proposed system.⁵⁴

56. **Establish an oversight body for the audit profession with standard-setting powers [specific legislation].** Recognizing the distinctive responsibilities of independent auditors toward the public and the consequent need to monitor the audit practice and ensure financial statements audits meet acceptable levels of quality, Dominican authorities should seek to introduce an independent body to oversee the audit profession. This would be consistent with the trend recently observed in several countries throughout the world, where self-regulation is being replaced by public oversight.⁵⁵ A new law should be passed introducing an Audit Oversight Board (AOB) with delegated functions from other regulatory agencies to monitor and enforce auditing standards and professional code of conduct.⁵⁶ To ensure its independence and neutrality,

⁵³ A company that meets the criteria of a PIE cannot, by definition, be an SME.

⁵⁴ Dominican authorities have expressed the view that publication of audited statutory financial statements should only be required from listed companies. The ROSC Accounting & Auditing considers nonetheless that this requirement should also apply to large enterprises, as is the case in many jurisdictions (including all EU member countries and Brazil) as this is part of their social responsibility and is necessary to ensure a minimum level of transparency in the private sector. Moreover, the cost associated with publishing audited statutory financial statements would be minimal in the case of the DR, since the obligation to prepare such statements is already established in the Code of Commerce of 1953.

⁵⁵ Examples of such oversight boards include the Canadian Public Accountability Board, France's *Haut Conseil du Commissariat aux Comptes*, the Irish Auditing and Accounting Supervisory Authority, Spain's *Instituto de Contabilidad y Auditores de Cuentas* (ICAC), the UK's Financial Reporting Council, and the Public Company Accounting Oversight Board in the US. At the international level, IFAC has recently established a Public Interest Oversight Board 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."

⁵⁶ An alternative to enacting a Law would be, at least for the short to medium term, a formal agreement between all institutions that currently are legally empowered to exert some form of regulation over the audit profession (including the various Superintendencies, ICPARD, DGII, and Chamber of Accounts). Ultimately, however, it would be preferable to embed the oversight system in a specific Law as was done in most countries where it has been introduced (e.g., Spain in 1989 for ICAC, the US in 2002 with the Sarbanes-Oxley Act, and France in 2003).

a majority of the AOB's members should be non-practitioners, including representatives of regulatory agencies and other concerned public authorities (e.g., DGII and Chamber of Accounts), academia, the financial community, and the civil society. Nominations should follow a due process to be provided in the Law or the Board's By-laws. Moreover, to be able to operate effectively, the AOB should be adequately funded; the existing stamp tax on audit reports could provide part of that funding. In addition, the sustainability of the AOB will be further ensured by the active participation of regulatory agencies, who would delegate staff and provide additional resources, as well as of the accounting profession.

57. **The proposed AOB should have wide-ranging responsibilities, including:**

- ***Licensing of statutory auditors*** – The license to conduct statutory audits in the DR should be awarded by the AOB to those professionals who demonstrate adequate technical knowledge and professional competence. In that regard, a process of certification, compliant with IFAC's International Standards of Professional Education (IES), would be the best solution. This process would include a minimum three-year experience in the audit practice and a professional examination. Additionally, the license would need to be renewed periodically, with continuing professional education being required for renewing the license. The conduct of the examinations could be delegated to ICPARD under strict guidelines guaranteeing the transparency and integrity of the licensing process. In the longer run, agreements could be sought with other countries for the mutual recognition of accountant/auditor certifications;^{57,58}
- ***Standard-setting*** – The AOB should oversee the process by which IFRS and ISA are implemented in the DR to ensure they can be understood and properly applied by Dominican preparers, auditors and regulators (see paragraph 36). Additionally, the AOB would be responsible for issuing a strengthened professional code of conduct and setting internal quality controls requirements for audit firms and sole practitioners, taking into account IFAC's corresponding standards; and
- ***Enforcement of professional standards*** – Compliance with auditing, ethical and quality control standards would be ensured through inspections and disciplinary measures as necessary. The law should give the AOB the power to require that statutory auditors provide any document related to their audits that they may require in their oversight role. The AOB should also have adequate sanctioning powers, including by repealing the license to conduct audits and imposing fines. This would not only deter non-compliance but it would also strengthen users' confidence in the financial information provided by Dominican companies and audited by Dominican practitioners.
- ***Reporting to the public*** – The activities, findings and decisions of the AOB, including sanctions taken against errant auditors, should be made public. This would increase the visibility and recognition of the audit profession in the DR, thereby contributing to increasing the confidence in audited financial information on the part of both domestic and international users. Publishing an annual report that evaluates the performance and progress of the auditing profession can also contribute to the stronger image of the profession.

⁵⁷ As is the currently the case between Canada, Mexico and the USA as part of the North American Free Trade Agreement (NAFTA). Mexico introduced the certification of public accountants in 2001. A similar project is currently under way in Chile.

⁵⁸ The Chamber of Accounts should primarily rely on the AOB's due process for the purpose of approving auditors among SOEs.

58. **Harmonize and strengthen academic curricula in the field of accounting and auditing.** The ongoing consultation between the various universities and the accounting profession for the harmonization of accounting curricula should serve as the basis for a standard of accounting education, consistent with IFAC's recommendations,⁵⁹ used as a basis for awarding the degree of public accountant (*licenciatura en contaduría pública*). This would ensure that future practitioners have acquired adequate academic background in the field of accounting and auditing to become accounting practitioners; it would also provide a good foundation for them later to seek AOB-sanctioned certification.

59. **As a means to safeguard auditor independence, the partner within an audit firm in charge of auditing statutory financial statements of public-interest entities should be rotated after a number of years to be set by the AOB.** This is already the case for banks (see Box 2). The company would not be forced to replace the audit firm, but the firm would have to propose a new partner responsible for the audit engagement. In the case of a company whose auditor is a sole practitioner, the company would need to appoint a new auditor.⁶⁰

60. **Require large corporate groups whose shareholding structure implies a higher degree of accountability to present audited consolidated financial statements [amendment to the Code of Commerce and/or the LMV].** Financial groups and other corporations with a large number of shareholders holding a significant share of the common stock should be subject to more stringent financial reporting requirements. Increased reporting obligations should also include semi-annual consolidated financial statements reviewed by an external auditor.⁶¹

61. **The function of *comisario* should be clarified by the statutes, and any redundancy with the role of the external auditor should be eliminated [amendment to the Code of Commerce].** The issue of whether or not there should be a form of compulsory external control within small and medium enterprises should be further discussed as part of the preparation of the country action plan. For companies obliged to have their financial statements audited, the best solution would be to combine the two functions and to eliminate those that can impair independence.

62. **Require that external auditors be invited to shareholders' AGM in all public interest entities [amendment to the Code of Commerce].** Any shareholder would thus be able to ask questions to external auditors on the financial statements, internal controls and issues involving the accounting and auditing processes. It would contribute to reinforce the rights of minority shareholders to seek clarification on the company's state of affairs and the financial impact of management decisions. Ultimately, this would help improve investors' confidence in the country's corporate system.

63. **Harmonize regulatory accounting standards for banks, insurance companies and pension funds with IFRS.** The fundamental objectives of financial statements, whether they are

⁵⁹ IFAC has published various standards and papers dealing with this matter, including IES 1, *Entry Requirements to a Program of Professional Accounting Education*, IES 2 *Content of Professional Accounting Education Programs* and IEG 9, *Prequalification Education, etc.*

⁶⁰ Mandatory rotation of the audit firm itself is required by very few jurisdictions (mainly Brazil and Italy). The audit profession worldwide is generally opposed to such measure, arguing that thorough knowledge of a company's business and processes is paramount to quality audits and that forcing companies to change their auditor therefore adversely affects the quality of the audits especially in the years following the change.

⁶¹ For instance, in Chile, a corporation with 500 or more shareholders and with 10% or more of its subscribed capital belonging to 100 shareholders or more is considered an open company and is subject to similar obligations as companies whose shares are publicly traded.

issued for general purpose (i.e. for investors, lenders and the public) or for regulatory purpose, are broadly the same, that is to provide a true and fair view of the reporting entity's financial position, performance and cash flows. These objectives are best served when sound accounting principles are applied in the preparation of the financial statements; in addition to allowing comparability on an international level, IFRS are widely acknowledged to provide principles of high quality. Accordingly, banks, insurance companies, pension funds and other regulated financial entities should follow IFRS in preparing their general-purpose financial statements.⁶² Aligning the regulatory accounting rules with IFRS would help increase users' understanding of, and confidence in, the general-purpose financial statements.

64. **Banking regulators should conduct a study for aligning the Banking Norms on loan loss provisions with IFRS and the Basel Committee's recommendations.** The study should be as comprehensive as possible and cover the impacts for banks in terms of a) the amount of provisions, b) Information systems supporting the monitoring and accounting of loans, and c) capacity building efforts required for banks to be able to apply a methodology consistent with IFRS and the Basel Committee's principles. The results of the study would likely be available in 2006, at which point the discrepancy between the target amount under IFRS-compatible rules and the amount of provision effectively recorded under the current gradual rule would be much lower if not limited.

65. **Implementing the recommendations of this ROSC is likely to require substantial technical assistance and capacity-building efforts.** As previously indicated, the country action plan will identify key activities including designing processes and organizational structures, drafting new legislation or regulation, and dealing with issues of human resources that would support the implementation of the ROSC recommendations and the related technical assistance. Furthermore technical assistance could be combined with twinning arrangements with institutions in other countries from which lessons can be learned on how to implement some of the ROSC recommendations, especially auditor certification and public oversight of the audit profession. Areas that could require significant technical assistance include:

- (a) ***Setting-up the public registry of corporate financial statements*** – Technical assistance will help define the detailed process for registering the financial statements, the links between the registry and other interested institutions to maximize its benefits and avoid any duplication (e.g., statistics department, DGII, and regulatory agencies), etc.
- (b) ***Establishing the AOB*** – Designing the By-laws and regulations under which the AOB will operate will require thorough legal analysis and consultation with regulators and stakeholders. Technical assistance will be needed to design the operating processes as well as for the corresponding recruitment, preparation and training efforts for its permanent staff. The content, cost and funding of this technical assistance will be provided in the country action plan, together with a preliminary estimate of the AOB's recurring budget. As for the introduction of a certification of external auditors, the leadership of the AOB should seek the cooperation of other Latin American countries that have already introduced it (e.g., Mexico) or are in the process of introducing it (e.g., Chile).

⁶² In a number of jurisdictions, when regulatory accounting principles differ with general-purpose accounting purposes, regulatory agencies require that the entities under their purview (banks, insurance companies, etc.) provide specific financial information for their regulatory purposes in addition to the general-purpose financial statements; in other jurisdictions, regulators ask for a separate set of regulatory financial statements (this is the case, for instance, in various countries in Europe)

- (c) ***Amending laws and regulations*** – Drafting amendments to the code of commerce and other laws and to existing regulations, so as to introduce improved and/or simplified requirements consistent with good international practice, may require the involvement of legal experts (see paragraph 53).
- (d) ***Regulators’ enforcement capacity*** – As previously noted, regulatory agencies either have recently been established or have recently begun to strengthen their capacity to enforce accounting and financial reporting requirements on regulated entities, and to perform in-depth analysis of corporate financial statements, conduct on-site inspections of companies, and reviews of auditors. The staff of regulatory agencies will also need to receive training so that they would be in a position to effectively enforce compliance with IFRS in the future. The technical assistance should also help those agencies identify human resources and funding needed to conduct these activities.
- (e) ***Aligning regulatory accounting rules for banks, insurance companies, etc. with IFRS*** (see paragraph 64)

66. **Insofar as they address the key strategic objectives of enhancing transparency and corporate governance and improving the investment climate for FDI, the recommendations of this ROSC would benefit a wide range of stakeholders in the DR, including:**

- ***Dominican enterprises*** – Increasing investors’ access to accurate financial statements and their confidence in the reliability of those statements will ultimately increase the availability of capital and help reduce the cost of financing for Dominican enterprises, including SMEs;
- ***Dominican investors*** – Compliance with international standards and enhancing the availability of financial information and the effectiveness of audits is a condition to the development of a securities market in the DR. It will lead to greater transparency on the market, and offers more investment opportunities to foreign or domestic investors;
- ***The banking sector*** – Making enterprises’ financial statements available will allow banks to carry-out comparative analysis of financial data within the same sector; combined with increased quality and reliability of the financial information, it will facilitate bank’s lending activities and help them decrease their exposure to credit risk;
- ***The public sector*** – Reinforcing accounting and auditing practices in the corporate sector would support the Government’s efforts to curtail corporate tax evasion in the country. It would also help mitigate the contingent liability associated with SOEs, as well as the risk for the DR of having to bail-out banks, pension funds and other public-interest entities.
- ***The Dominican accounting profession*** – Introducing adequate licensing requirements and quality assurance will elevate the confidence that investors and corporate entities place in external audits and accounting services. Increased recognition of the profession and perceived value of the services its offers will in turn allow an increase in revenues. In the longer run, the profession will also gain recognition abroad and Dominican accountants will be able to compete on an international level.⁶³
- ***Employees of the private and state-owned sectors***, who have an important stake in their company’s success, and are therefore entitled to receive complete and accurate financial information. In addition, more transparent financial information would help private pension funds make investment decisions and monitor the performance of their investments, which in turn would benefit future retirees.

⁶³ The proposed improvements would significantly align accounting and practices in the DR with those of neighboring Puerto Rico.

