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**Fonds:** Records of the Office of Operations Evaluation

**ISAD Reference Code:** WB IBRD/IDA OPE-01-02

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The World Bank/IFC/MIGA

**OFFICE MEMORANDUM**

DATE: April 26, 1995 06:12pm

TO: Betty Bain ( BETTY BAIN )

FROM: Randolph A. Andersen, ACTCO ( RANDOLPH A. ANDERSEN )

EXT.: 34772

SUBJECT: Accounting and Auditing Adviser's Group Meeting

Many thanks for arranging for Mr. Aguirre-Sacasa to have lunch with the AAA Group on May 16. It will be in E Dining Room #4 and will comprise Allan Legg (ECA), Al Kennefick (AST), Jim Wesberry (LAC), Douglas Graham (MN2), Hartwin Nickel (MN1), Colin Lyle (AFR), Hennie Van Greuning (PSD), George Russell (ACTCO) and me. Jules Muis may also join us, but not yet definite.

The topic for discussion during lunch would be "Corruption" to which Allan Legg's EM of 3/22 and Bob Picciotto's response of 4/03 would be the introduction. I am sure Francisco is also aware of Steve Berkman's paper concerning some corruption experiences in Africa to which reference will be made - we can send a copy if he does not have one. Does he also have a copy of our recently published Financial Accounting Reporting and Auditing Handbook (FARAH), which we can also send? Thanks.


CC: Francisco Aguirre-Sacasa ( FRANCISCO AGUIRRE-SACASA )




# OFFICE MEMORANDUM

DATE: March 20, 1995

TO: Francisco Aguirre-Sacasa, Acting DGO

THROUGH: Alain Barbu, Acting Chief, OEDD3 

FROM: Jean-François Landeau  OEDD3

EXTENSION: 31692

SUBJECT: Audit Compliance and Financial Management in Bank Assisted Projects

1. This refers to Memorandum from Jules Muis, Vice President and Controller, dated March 8, 1995, on the Audit Compliance and Financial Management (ACFM) in Bank Assisted Projects. As requested by Mr. Manuel Penalver last week, we have reviewed the memo and its accompanying report. Our findings and comments are presented below.

2. The report's main conclusions are as follows:

- a) ACFM has not been widely adopted across the Bank in projects and the ARPP 1994 has very little mention of actions taken and does not indicate that ACFM is used as a tool for improving Quality at Entry and project management in general;
- b) Country assessments of financial management, accounting and auditing capabilities have been introduced in a limited number of countries; however, the ARPP 1994 does not suggest any plans for a wide spread introduction of these reviews to reinforce institutional and professional contribution for subsequent project component design; and
- c) In general, the Regions appear to see no serious skills shortage of financial and management accounts in the Bank.

3. The report then notes that the Financial Accounting, Reporting and Auditing Handbook (FARAH, to be available by end-March 1995) presents the best practices. It further suggests increased training in the above areas and better recognition and commitment across the Bank "to weave financial management, including accounting and auditing, into the fabric of project design, implementation and management". The report finally recommends the adoption of some fundamental actions in: (i) clarifying that project (legal) documents include specific reference to the financial management (including accounting, auditing arrangements, financial reporting, etc); (ii) improving the supervision of audit function and other financial reporting of projects (including the issuance of specific TOR to this effect); (iii) enforcing, more strongly than in the past, financial covenants by the Bank; and (iv) strengthening the skills of Bank staff who will review the audit reports and improving the timeliness of Bank response.

4. In general, our findings from the PAR work support the above findings. We have found many situations of insolvency that were not flagged in Bank supervision reports. As the report argues, this is likely an indication of the lack of qualifications in accounting and finance among Bank staff (one notable exception is the Africa Region which has accountants in the Technical Department). External audits are tools that should be carefully reviewed and issues raised therein should be reported back to Borrowers. Regrettably however, we do not find evidence of this when reviewing project files as part of our audit work.

5. Overall, the report provides a useful analysis of Bank practices. Yet, we have a problem with the discrepancy between the proportions of: (i) audits qualified by external auditors, and (ii) projects with "serious accountability issues" as reported by Bank staff (the latter being much lower than the former). Qualifying accounts is a serious matter and it cannot be discounted by the opinion of staff who (we are told in the report summary) generally lack the qualifications in accounting and finances.

6. We fully endorse the recommendations. Similar recommendations have been made earlier, but actions so far have unfortunately been limited. For tangible results, perhaps it would be better to focus, as a first step, on external audit issues, such as (i) delays in producing audit reports; (ii) specific aspects that each external audit should cover as a minimum; and (iii) actions that the Bank should take as feedback, followed by addressing broader issues of financial management.

cc: Messrs. Picciotto o/r, Guerrero (DGO)

WORLD BANK OFFICE TRACKING SYSTEM  
Director General, Ops Evaluation  
Routing and Action Transmittal Sheet

TO:

OEDDR, (T-9025)

DATE:

3/13/95

SUBJECT DOCUMENT:

From: J. MUIS

To: REGIONAL VPS (BY NAME)

Dated: 3/08/95

Reference No.: DGO950313003

Topic: AUDIT COMPLIANCE AND FINANCIAL LMANAGEMENT IN BANK ASSISTED  
PROJECTS

ACTION INSTRUCTIONS:

DUE DATE:

HANDLE

XXX

REVIEW AND RECOMMEND

FOR YOUR INFORMATION

DISCUSS WITH

AS WE DISCUSSED

PREPARE RESPONSE FOR SIGNATURE

FOR YOUR FILES

RETURN TO

OTHER:

3/16/95

Remarks: MP (CC: PG) - PLEASE ARRANGE FOR A REVIEW OF THIS REPORT



# OFFICE MEMORANDUM

DATE: March 8, 1995  
 TO: Messrs. Burki (LACVP), Jaycox (AFRVP), Cheetham (EAPVP),  
 Koch-Weser (MNAV), Thalwitz (ECAVP), Wood (SASVP)  
 FROM: Jules Muis, Vice President and Controller  
 EXTENSION: 81674  
 SUBJECT: Audit Compliance and Financial Management in Bank Assisted Projects

RECEIVED

95 MAR 10 PM 4:38

DGO

cc: PG

17P

Please arrange  
for a review  
of this  
report.

1. Attached for your information is the annual memorandum prepared by ACTCO which not only discusses Audit Compliance but also the role of Financial Management in Bank assisted projects.

2. While the report shows that we continue to make progress with our audit compliance covenants, I am sure you will agree that we cannot be satisfied with an 81% compliance with reports received some 12 to 15 months after the period in which funds are spent. This is well below what would be accepted practice in the banking sector, particularly where 16% of the reports received (representing \$3 billion of project expenditures) are qualified for one reason or another. On top of this, we have \$5-6 billion of FY 94 Bank disbursements subject to SOE procedures and post procurement reviews, with little or no examination by Bank staff.

3. The objectives to fulfil the Bank's fiduciary responsibility and at the same time to ensure adequate financial management and information are overarching objectives, and both are dependent upon good accounting and auditing. The shortfall in audit compliance means, to a large extent, that the underlying project accounting and auditing systems to produce timely, reliable financial information are deficient. It is important, beginning at *Project Entry*, to weave this into the culture and attitude of the institution if the Bank is to maximize its impact on development.

4. I would like to meet with your Regional management team to discuss the findings and recommendations in the report. I would also like to review with you any problems of skills-mix associated with the report and review some of the broader issues on borrower accountability raised in the FRAT report. In the meantime, if you have any particular questions with respect to the details of the report, please call Randolph Andersen (ext. 34472) or George Russell (ext. 32357).

Attachment

cc: Messrs./Mmes.: Frank, Kaji, Sandstrom (EXC); Shihata (LEGVP); Picciotto/Kopp (OED); Serageldin (ESDVP); Choksi (HROVP); Rischard (FPDVP); Joscelyne/ Walden/Saunders (IADDR); Adams (OPRDR) Wijnand (OPRPG); Ruddy (ACTDR); Ayub (AFRVP); Kohli (EAPVP); Drysdale (SASVP); Blanchi (ECAVP); Husain (MNAV); Alexander (LACVP); Cleaver (AFTDR); Messenger (ASTDR); Sood (EMTDR); Aiyer (LATDR); Andersen, Russell, Morson (ACTCO)



# OFFICE MEMORANDUM

DATE: March 8, 1995  
TO: Mr. Jules Muis, Vice President and Controller  
Through: Mr. Michael E. Ruddy, Director, ACT  
FROM: Randolph A. Andersen, Division Chief, ACTCO *mzr Andersen*  
EXTENSION: 34772  
SUBJECT: Audit Compliance and Financial Management in Bank Assisted Projects - Annual Review

1. This memorandum addresses the issue of borrowers' accountability in Bank assisted projects, and the role of financial management in project implementation and management. The review is based mainly on annual regional reports on the status of audit compliance for FY 94, and comments on issues of borrowers accountability included in the Annual Report on Portfolio Performance (ARPP). This has been supplemented by ACTCO analysis where regional reports have fallen short. Section A provides the overall summary and recommendations and Section B the detailed review of compliance with Audit Compliance. *Comments*

## Section A: Summary

2. Audited financial reports are an important part of the Bank's fiduciary responsibility to ensure that project funds are used for the purposes intended. This fiduciary responsibility is normally fulfilled through a three pronged approach, whereby the Bank (i) requires adherence to its procurement procedures; (ii) relies on supporting documentation as a basis for its disbursements; and (iii) requires an independent audit, which in addition to the physical examination of documentation, ensures that management and financial controls are sufficient to ensure the legitimacy and eligibility of procedures and expenditures reflected in the documentation. It is important to note that the audit is not merely a verification of documentation and, for example, the audit of SOE documentation requires the support of the overall audit of the project/project entity.

3. The audit has become increasingly important as limitations in the first two prongs mentioned above have emerged. Recent studies in the Bank concluded that field review by TMs of SOEs, which form an increasing percentage (40% in FY 94) of Bank disbursements, and procurement documentation subject to post review procedures (estimated at \$ 5 billion) are seldom carried out, and that most staff do not assign this aspect of supervision a high priority. While the Bank is currently looking at ways to mitigate this problem, including the possible help of third party verification other than audit, the entire scenario elevates the need for timely and efficient audits.

4. The general emphasis of the comments in the ARPP and in the regional reviews of the Audit Reporting Compliance System (ARCS) substantiate the general view that the driving force for the receipt of audit reports is mainly to fulfill what is frequently viewed as the Bank's bureaucratic requirement. It is interesting to note that the regional and sectoral contributions to the ARPP, in emphasizing the importance of Quality at Entry, made only limited reference to the role of financial management as an important requirement both for the borrower and the Bank. It is important to draw a linkage between portfolio performance and project financial management. The Portfolio Management Task Force (PMTF) included among other factors, poor management and poor implementation as contributing to declining portfolio performance. Financial accountability and reporting are



fundamental to good management and where there are weaknesses, management suffer. Since the PMTF, management has introduced several initiatives to improve portfolio performance with "Improving Quality at Entry" being one of the foremost. However, much more needs to be done to ensure that acceptable controls, accounting, reporting and auditing arrangements are in place from the very beginning of the project, if Quality at Entry is to be achieved. In the ARPP's discussion of Restructuring of projects, no reference is made to the role of on-going monitoring, both financially and physically, which allows the early identification of problems thereby providing the opportunity for remedial action, change of course, etc., thereby reducing the need for major restructuring. In general, very little attention is being given in the Bank to the wider role of financial management as an important tool for the borrower to manage and implement projects, and for the Bank (TM) to monitor project progress. Timely and complete financial reporting designed to meet the needs of individual projects should be a must for project implementation and management. Once this is available, one usually finds that the audit process falls automatically in to place.

5. Several Bank departments have introduced action plans to improve the timely receipt and quality of audit reports. The best practices are summarized in the Financial Accounting, Reporting and Auditing Handbook (FARAH) available for wide distribution by end-March 1995. However, while improved guidelines and increased training are vital, one of the most important factors for improved project implementation and management would be the recognition and commitment across the Bank to weave financial management including accounting and auditing into the fabric of project design, implementation and management. It may also be argued that this change in focus will not necessarily require additional resources but instead a repositioning of resources, and that good and timely information will ultimately save time and cost and improve the development impact, as well as reduce the need for project restructuring during implementation because of going off track.

6. Unfortunately, as the Financial Reporting and Auditing Task Force (FRAT) report concluded, the current status of project accounting and auditing requires much improvement, with lack of timeliness for the receipt of the reports and inadequate quality being the two main weaknesses. Most Bank staff have begun to address the issue of "timeliness", however, less has been done with respect to "quality" which is a more difficult problem and one that requires the involvement of skilled staff, with strong and consistent commitment across the Regions. Presently, there is a lot of skepticism about the quality and acceptability of the audit reports received as they suffer from inadequate clarification to the borrower and auditors by Bank staff as to what is required, and from inadequate review and follow up when received in the Bank. This is (a) because adequate arrangements for financial management, accounting and auditing is not sufficiently emphasized during the project preparation and appraisal stage; and (b) reports received are frequently not reviewed and where done, it is often by staff without the expertise and training to adequately carry out these reviews.

7. The guidelines to the Regions for the annual ARCS review requested an update of the status of Management's Action Plan forming a part of the FRAT report, on which we are required to report as a part of the Next Steps to the PMTF Report due end March 1995. The major aspects of the Action Plan and their status are summarized below.

- (a) "The development and utilization of financial management as a key aspect of project management by the borrower and for project monitoring by the Bank." While this approach has been adopted in some projects, there is no evidence that this has been adopted as a wide spread practice across the Bank. For example, the ARPP has very little to say about any actions taken and did not indicate any



strong commitment to the utilization of financial management in its discussion of Quality at Entry, and project implementation and management in general.

- (b) "The introduction of country assessments of financial management, accounting and auditing capabilities for those countries with problems beyond that of concerned projects." Country assessments have been introduced in a limited number of countries, however, neither the ARPP nor the ARCS indicated plans for a widespread introduction of these reviews. Identification of regulatory weaknesses and institutional/professional reinforcement needs for subsequent project component design are important contributions to sustaining improved accountability.
- (c) "To review skills needs with respect to the increased emphasis on the role of financial management in project implementation and the review of audit reports and other financial information." There appears to be "no" strong belief among the Regions that there is a serious skill shortage of financial and management accountants in the Bank. This is directly related to the need for an increased awareness of the role of financial management as a critical component in project management.

8. The results of the FRAT report and the review of actions subsequently taken indicate that in addition to the best practices summarized in the Bank's policy, guidelines and handbooks, some fundamental actions are required. The adoption of the following recommendations should have very positive impacts:

- (a) The legal covenants require accounting and auditing acceptable to the Bank. However, there is usually no linkage between this statement and what is specifically asked for. Projects are frequently processed and approved without either the borrower and the TM agreeing what is needed for the financial management and monitoring of the project. As an important aspect for improving Quality at Entry, it is recommended that project documents be mandated to include specific reference to the financial management including accounting and auditing arrangements in place, and the financial and other reporting formats required for the implementation, management and monitoring of the project. The relevant OMSs and OPNs (not yet in OPs) have required this for over a decade. The regional clearance for Board presentation should include procedures giving an assurance to the above, e.g. similar to procurement. Assurance that such arrangements are in place, as is required in OP12.0 should be given to the Loan department before the first disbursement.
- (b) All projects should require timely and appropriate "unaudited accounts" and other reporting to the borrower as necessary for project management, with periodic copy to the Bank as agreed. Subsequent audit will attest as to the reliability of these unaudited accounts. Terms of reference should be issued for each audit, which should include as necessary special requirements associated with covenant compliance and topics such as third party verifications (e.g. post review with respect to procurement).
- (c) The Bank should be stronger in enforcing financial covenants, with exceptions made where there is reasonable justification. In the longer term, disbursements will not suffer once borrowers believe that the Bank is serious about its covenants and requiring proper accountability.



- (d) All audit reports should be reviewed on receipt with qualified and/or experienced regional or departmental advisers available to provide assistance where necessary. Some regions may find it advantageous to create a small staff cluster for providing such support. It is important that this review be supported by periodic field reviews to ascertain the capability of the auditors and the quality of their work, and more particularly of the accounting which is often the weaker part.

9. Section B, which follows, summarizes the review of Compliance with Audit Covenants including the role of the ARCS and Central and Operational Accounting Division (ACTCO) as well as coverage on the special topic of hyperinflation.

## **Section B: Detailed Review**

### **Compliance with Audit Covenants**

10. The review of Compliance with Audit Covenants was carried out as at end December 1994 (using January 6, 1995 as the cut off date). Instead of the usual half year review at June 30, 1994, the Regions were asked to include as a part of their contribution to the Annual Report on Portfolio Performance (ARPP) a comprehensive discussion of financial management, accounting and auditing issues. This review was updated as at end December, 1994 to provide information for this report.

11. The discussion is supported by Tables I and II which summarize compliance status by Regions for Bank FY 94, with comparisons for FY 93 and FY 92; showing percentage of audit reports received, types of auditor (government or private), auditors opinion (unqualified or other), and note of serious accountability issues. As Table I shows, the Bank eventually receives 97 per cent of all reports due; the 3 percent balance relating mainly to projects closed without the audit reports ever being received. However, lack of timeliness for the submission of these reports continue to be a major problem, with only 81 percent of reports due for FY 94 being received at end December 1994. While this is a 3 percent improvement over the previous year (FY 93 review showed 78 percent received at the same time), it should be noted that end December 1994 is already 6 months after end FY 94, and reports are only shown as due after the normal grace period of six to 9 months. This means that these outstanding audit reports are already a total of 12 to 15 months after the end of the respective fiscal year of the project and/or project entity to which they relate. In fact, only about 45 percent of project audit reports are received on their due date.

12. Overall, the percentage of projects audited by government auditors and private auditors are about equal. However, there is quite a difference between Regions. The two Asia Regions have most of their audits carried out by government auditors (EAP 93 percent and SA 75 percent). On the other hand, AFR and LAC have most of their audits carried out by private audit firms (84 and 74 percent, respectively), while MNA has an equal division of government and private. The 3 latter Regions also have the highest number of qualified opinions. However, we need to look more closely at the independence of the Asia Regions' government auditors as to their independence and approach to the qualification of audit reports.

13. On average, 84 percent of audit reports received are unqualified, with 16 percent having either a qualified, adverse or disclaimer status in their audit opinion. About 8 percent of projects are considered by staff to have serious accountability issues, with AFR



having the highest at 13 percent. However, there is not necessarily a connect between both percentages as some projects with serious accountability issues may not have been qualified.

#### **Comments on Compliance and Actions on a Regional Basis.**

14. The review shows minimum difference in compliance between the Regions over the long term (after 3 years - FY92), however, there is a more marked difference in the shorter term, with the two Asian regions leading with over 90 percent compliance in FY 94 compared to lows of 68 percent in MNA and 77 percent in AFR. However, this comparison is tainted due to the different grace periods allowed for the submission of audit reports, with most Asian projects allowed 9 months after their fiscal year end compared to the normal 6 months allowed. In addition, the difference between the fiscal year of a project (e.g. whether March 31 or December 31) and the date of this review also affects the comparison. An analysis of regional responses follows in paras. 6 - 23.

15. *Africa Region (AFR)* accounts for 30 percent of all audit reports required by the Bank. While still being one of the poorer performing regions, it improved its timeliness by 2 percent over the previous year, received 4 percent more of unqualified reports, with 3 percent less projects having serious accountability issues. Some of the above problems are due to countries undergoing or recently emerging from political strife.

16. This Region has demonstrated a serious commitment for the strengthening of borrowers accountability in general. It is the only region with a Financial Management cluster in its Technical Department staffed by -- trained accountants, fully concerned with providing support to TMs in financial accountability and related activities. All country departments have audit coordinators with trained accountants in some of its larger resident missions (Nigeria and Tanzania). Actions taken include vigorous monitoring and follow up of audit reports becoming due, strong enforcement of project conditionalities and increased involvement of resident staff.

17. The quality of the reports received continue to improve, benefitting from capacity building projects to strengthen national accounting capabilities (e.g. Tanzania, Zambia, Uganda and Madagascar), and the routine discussion of accounting and audit issues in CPPRs. The Region has been quite active in introducing training programs for both staff and borrowers, and has initiated several studies in related areas. However, several countries still suffer from underlying accounting and auditing problems and government auditors, in particular, have limited qualifications and training.

18. Country assessments were carried out in 4 countries in 1994 (Kenya, Malawi, Senegal and Zimbabwe) and the results will be used to develop and recommend remedial programs. Other are planned for FYs 95/96. Three countries (Angola, Ghana and Zaire) fall into the range of hyper inflationary countries (100 percent inflation over a three year period), however only Ghana has introduced accounting standards to deal with this issue which requires restatement of financial statements. In addition, the CFA countries which recently made significant devaluations in their currency, are with the assistance of France still studying the situation.

19. *East Asia Pacific (EAP)*, accounts for 20 percent of audit reports required, with 81 percent compliance for FY 94. While 7 percent of audit reports are qualified, staff believes that only 1 percent have any serious accountability issues. In this region, 93 percent of audits are carried out by government auditors. About half the larger borrowers in



this region have professional accounting societies with linkages to IFAC. The government auditors in these countries are members of INTOSAI. The higher level of government auditors and lower level of audit reports would seem to beg the question of independence which should be thoroughly examined.

20. The issue of quality in this region mainly relates to inadequate guidance from TMs to auditors as to the Bank's requirements, particularly with respect to project accounts, SOEs and special accounts. With the assistance of written guidelines, which have been distributed widely to borrowers and auditors plus training to TMs, the region is beginning to see improvements. Initiatives include assistance to TMs to ensure adequate project accounting in new projects. The region shares an Accounting and Auditing Advisor (recently added an experienced professional accountant to the team) with SA. In addition, the region is reviewing its additional needs including the involvement of local professional accountants in resident missions.

21. Special initiatives include (i) a technical assistance project in China supporting the development of new accounting and auditing standards based upon international standards (although China is not yet a member of IFAC and IASC), and through specific investment loans, the modernization of enterprise accounting in the telecommunications and railways sectors; (ii) executing a UNDP - financed privatization program with a significant accounting component, to be followed by a possible IDF grant to improve the government's accounting system; (iii) in Mongolia, a program to support the country's accounting and auditing capabilities, including the provision of a market oriented accounting and financial management. Similar initiatives are planned for Laos and PDR; (iv) in the Philippines, there are plans to provide support to the Commission on Audit on project specific accounting and reporting systems; and (v) for Indonesia, a further accounting upgrading project was recently approved by the Bank.

22. *South Asia Region (SA)* accounts for 18 percent of audit reports required, and at 91percent has one of the two highest compliance rates. However, 18 percent of its reports are qualified with about half considered to have serious accountability issues. This region also has a high percentage of government auditors ( 75 percent). India, Pakistan, Bangladesh and Sri Lanka, who are the larger borrowers have professional accounting societies linked to IFAC and the government auditors are INTOSAI members.

23. The issue of quality in this region is similar to that in EAP, mainly relating to inadequate guidance from TMs to auditors as to the Bank's requirements, particularly with respect to project accounts, SOEs and special accounts. With the assistance of written guidelines, which have been distributed widely to borrowers and auditors, and training to TMs there is a beginning of improvements. Initiatives include assistance to TMs to ensure adequate project accounting in new projects. The region shares an Accounting and Auditing Advisor (recently added an experienced professional accountant to the team) with EAP. In addition, the region is reviewing its additional needs including the involvement of local professional accountants in resident missions.

24. Special initiatives include (i) an on-going technical assistance project in Pakistan under which has been developed an effective performance audit capability including the publication of a set of Performance Auditing Guidelines. Plans are in progress to develop a project for the modernization of the government's accounting system; (ii) in Nepal, the strengthening of the Office of the Auditor General; and (iii) discussing with the India Auditor General's office a program for supporting the development of an operational audit capability.



25. *Europe and Central Asia Region (ECA)*, which only accounts for 7 percent of audit reports required, includes several countries which only recently joined the Bank and represents a rapidly changing scene. In many of these countries, market oriented accounting and auditing is only in the development stage and most audits are currently carried out by international firms at high costs, particularly when compared to local costs. In spite of the above, the region, at 92 percent, has one of the better compliance rate for FY 94, an improvement of 13 percent over the same time last year. About 9 percent of reports were qualified with some of these qualifications only represented differences between local standards and international standards relating to issues which are likely to be soon resolved (asset valuation and treatment of depreciation) as local standards are revised. The use of public and private auditors were about equal. However, as more projects require audits and borrowers require the use of local auditors to mitigate the high costs, it may be difficult to maintain these percentages without corresponding development at the country level.

26. Special initiatives include assistance to Turkey in preparing a feasibility study for a proposed program for the Development of Accounting, Financial Reporting and Auditing Services which will support the local accounting profession. With the involvement of resident missions, training was given to local project staff in Bank's accounting and audit requirements. Initial country assessments on accounting and auditing capabilities are being carried out for several countries with other planned for FY 95/96.

27. To meet the wide challenges, particularly for accounting assessments and reforms towards market oriented accounting necessary in several of the countries in this region, the region appointed a Senior Advisor with respect to auditing matters and an advisor concerned with the reform process in the Former Soviet Union countries.

28. *Latin American and Caribbean Region (LAC)*, which accounts for 18 percent of audit reports required by the Bank only has a compliance of 73 percent for FY 94, but a 2 percent improvement over that of the previous year. In this region, 15 percent of reports were qualified and Bank staff believed that 11 percent of projects have serious accountability issues. Most audits are carried out by private auditors (74 percent of total). The issue of timeliness in this region suffered from the reorganization of divisions and change in TMs, and the need to carry out a complete examination of the ARCS in accordance with ACTCO's suggestion provided in the guidelines for this review. Plans are being put in progress for this exercise and for training staff who will be made responsible for maintaining and monitoring the system.

29. To ensure that the audit reports received meet acceptable quality, the region has introduced procedures to strengthen desk reviews of reports received, including increased support from qualified professional staff where necessary. It has developed with the Inter-American Development Bank (IDB) and selected donors a collaborative effort to ascertain the acceptability of audit agencies and firms and to introduce periodic quality control reviews. In addition, LAC is cooperating with the LAC Donor Consultative Group on Improving Government Financial Management ( a group involving the Bank, USAID, IDB), which is involved in the development of financial management including auditing in the region.

30. The region recently employed an experienced professional accountant as its Regional Adviser, who has been supported almost full time by an accounting professional from ACTCO and recently added a long term consultant. This initiative has been supported by departmental working groups concerned with the inclusion of adequate financial management including accounting and auditing in projects. Country assessments are being introduced on a progressive basis, with the first major one planned for Peru. Projects with



financial management components are currently being implemented in Bolivia, El Salvador, Venezuela and Mexico.

31. *Middle East and North Africa (MN)*, only accounts for 7 percent of audit reports required. While it eventually receives 95 percent of audit reports due, it continues to have the worst record among the regions at 68 percent (no change from the previous year) with respect to FY 94 reports received. Some delays are due to governments' procedures for clearing the reports (Central Organization for Control and Audit in Yemen and Egypt - COCA) before they are submitted to the Bank, civil disturbance in Yemen which has a sizeable portfolio, and weaknesses in project financial management and accounting. About 27 percent of reports received were noted as qualified even though staff believed only 4 percent of projects have serious accountability issues, explaining that the qualifications were not serious. One explanation for the high number of qualified opinions are that they are first time audits in situations where no adequate accounting and information systems were in place at project entry.

32. To improve performance, the region has intensified its action plan introduced in 1993, focussing on regular follow up by TMs, with division and department regular overviews, and the conditioning of new loans on acceptable audit compliance. The region has no full time Accounting and Auditing Adviser on staff and rely on two departmental part time coordinators, and on assistance contracted from ACTCO or Internal Audit when considered necessary. CPPR discussions now routinely include accounting and auditing as a topic. Special initiatives included the assessment of audit capabilities on a country basis (e.g. Morocco, Tunisia and Iran) with audit action plans for strengthening audit capacity where necessary. A review is ongoing for Egypt, and the results of the Yemen review carried out in the previous year is under discussion.

#### **Actions Taken**

33. To varying degrees, the regions have introduced follow up procedures to improve compliance with audit covenants. However, many of the problems are associated with the lack of good accounting "at Entry" and the need for capacity building at the country level. Some important initiatives introduced by some departments are:

- (a) the creation of working groups to discuss and resolve auditing problems;
- (b) increasing the role of resident missions including the engagement of local professional accountants both as employees and as consultants;
- (c) stronger enforcement of covenants e.g. requiring compliance of on-going projects before Board presentation of new projects;
- (d) increased participation in training programs, with some regions promoting their own training of staff in accounting and auditing related matters; and
- (e) increased use of terms of references for audit engagements.

However, staffing continues to be a problem due to the limited number of accounting professionals involved with the development of financial management and accounting systems, and available to provide support in the review of audit reports received and the performance of auditors in general.



## ARCS

34. The ARCS system has come in for criticism by some regions. However, the main problems relate to the management of the system on an on-going basis, lack of training of those responsible for inputs, need for greater participation by TMs with respect to the review and interpretation of reports received, and clearer guidelines and control at the departmental level with respect to input and adjustments to the system. There is the tendency in some departments to address the problems of the system to coincide with the periodic review of audit compliance rather than monitoring it on a regular basis. The guidelines dated July 27, 1994 for the review of audit compliance clearly suggested "before the review, we suggest that you examine current data in the ARCS as applicable to your Region". In addition, at the review date, there were several projects missing initial information in the ARCS (see Report 104 of the ARCS). It is suggested that Internal Audit carry out a review particularly of those regions reporting problems to comment on the reliability of the inputs into the system.

## ACTCO

35. ACTCO continues its role to provide leadership and support with respect to matters of borrowers accountability. In addition to providing advice on request, and field support (particularly in LAC countries), the Financial Accounting, Reporting and Auditing Handbook (FARAH) was completed and will be available for distribution to all TMs and others before end March 1995. OP/BP 10.02 to replace OD 10.60 is now in draft, and the Guidelines - Financial Reporting and Auditing of Projects Financed by the World Bank (1983) is currently under revision. ACTCO introduced in collaboration with the Training Department, training courses - Project Accounts at Entry and Introduction to Auditing, designed to address real life Bank projects. In addition, ACTCO sponsored several other initiatives associated with the review, discussion and dissemination of international and other best practices and standards. In addition, ACTCO is very active internationally, representing the views and concerns of the Bank and our borrowers with those responsible for setting the rules, standards or ethics for the accounting and auditing profession.

36. ACTCO staff will set up a series of Regional and Departmental meetings to discuss the handbook (FARAH) which will be available for distribution by end-March 1995 along with several concerns, particularly to focus on (i) quality at entry, and (ii) how to improve and develop sustainable borrower accountability.

## Special Topic

37. The review required comments with respect to those countries in a hyper-inflationary situation (as defined in International Accounting standard 29 as 100% compounded inflation during any three year period). No such countries were reported by the Asia, LAC and MNA regions. However, LAC has countries with a history of hyper inflation (e.g. Brazil and Argentina) which both have appropriate standards. AFR identified three such countries of which one (Ghana) has introduced appropriate practices, while Angola and Zaire have no appropriate standards. In addition, the CFA countries are examining their needs for standards (see para. 9 above). While the ECA region offered no comments, Russia and several of the Former Soviet Union countries suffer from hyper inflation. However, the issue for the adoption of international standards is being addressed by some countries, and will need to be monitored on a project basis for the time being. This issue is extremely important, especially where there is any intention to privatize public enterprises, to ensure that both assets and liabilities are properly valued



and/or restated. The absence of comment by some Regions also suggests the severe lack of understanding among many Bank staff and managers of issues and repercussions of hyperinflation on financial statements.

George Russell/mn

Table I

**AUDIT COMPLIANCE**  
(As of December 31, 1994)

|                                      |       | AFR                  | EAP | SA  | ECA | LAC | MNA | Combined |
|--------------------------------------|-------|----------------------|-----|-----|-----|-----|-----|----------|
|                                      |       | -----Percentage----- |     |     |     |     |     |          |
| <b>Reports Received</b>              |       |                      |     |     |     |     |     |          |
| At December 31, 1994                 |       |                      |     |     |     |     |     |          |
|                                      | FY94  | 77                   | 81  | 91  | 92  | 73  | 68  | 81       |
|                                      | FY 93 | 95                   | 94  | 99  | 99  | 94  | 89  | 94       |
|                                      | FY 92 | 97                   | 98  | 100 | 98  | 98  | 95  | 97       |
|                                      | FY 95 | 36                   | 55  | 39  | 81  | 39  | 38  | 46       |
| <b>Types of Auditors</b>             |       |                      |     |     |     |     |     |          |
| Government                           | FY 94 | 16                   | 93  | 75  | 44  | 26  | 49  | 49       |
|                                      | FY 93 | 19                   | 92  | 71  | 42  | 34  | 45  | 48       |
|                                      | FY 92 | 19                   | 90  | 70  | 51  | 40  | 46  | 51       |
| Private                              | FY 94 | 84                   | 7   | 25  | 56  | 74  | 51  | 51       |
|                                      | FY 93 | 81                   | 8   | 29  | 58  | 66  | 55  | 52       |
|                                      | FY 92 | 81                   | 10  | 30  | 49  | 60  | 54  | 49       |
| <b>Auditors Opinion</b>              |       |                      |     |     |     |     |     |          |
| Unqualified                          | FY 94 | 80                   | 93  | 82  | 91  | 85  | 73  | 84       |
|                                      | FY 93 | 76                   | 89  | 90  | 87  | 77  | 78  | 83       |
|                                      | FY 92 | 78                   | 91  | 86  | 91  | 74  | 71  | 81       |
| Qualified/Adverse<br>/Disclaimer     | FY 94 | 20                   | 7   | 18  | 9   | 15  | 27  | 16       |
|                                      | FY 93 | 24                   | 11  | 10  | 13  | 23  | 22  | 17       |
|                                      | FY 92 | 22                   | 9   | 14  | 9   | 26  | 29  | 19       |
| <b>Serious Accountability Issues</b> |       |                      |     |     |     |     |     |          |
| (Bank Staff Opinion)                 |       |                      |     |     |     |     |     |          |
| No                                   | FY 94 | 87                   | 99  | 91  | 91  | 89  | 96  | 92       |
|                                      | FY 93 | 84                   | 96  | 94  | 86  | 88  | 90  | 90       |
|                                      | FY 92 | 85                   | 89  | 90  | 93  | 86  | 87  | 88       |
| Yes/Unsure                           | FY 94 | 13                   | 1   | 9   | 9   | 11  | 4   | 8        |
|                                      | FY 93 | 16                   | 4   | 6   | 14  | 12  | 10  | 10       |
|                                      | FY 92 | 15                   | 11  | 10  | 7   | 14  | 13  | 12       |



# **AUDIT COMPLIANCE** Summary Report as at December 31, 1994

|  | FY 92       | FY 93       | FY 94       |
|--|-------------|-------------|-------------|
| 1. Total Reports:  |             |             |             |
| Reports Overdue  | 88          | 233         | 897         |
| Report Received  | <u>2950</u> | <u>3692</u> | <u>3819</u> |
|  | <u>3038</u> | <u>3925</u> | <u>4716</u> |
| 2. Audit Reports Overdue:  |             |             |             |
| Financial Statement  | 20          | 62          | 204         |
| Project Account  | 17          | 49          | 240         |
| SOE  | 29          | 70          | 237         |
| Special Account  | <u>22</u>   | <u>52</u>   | <u>216</u>  |
|  | <u>88</u>   | <u>233</u>  | <u>897</u>  |
| 3. Audit Reports Received:   |             |             |             |
| Financial Statement  | 697         | 862         | 866         |
| Project Account  | 764         | 980         | 1024        |
| SOE  | 815         | 1014        | 1077        |
| Special Account  | <u>674</u>  | <u>836</u>  | <u>852</u>  |
|  | <u>2950</u> | <u>3692</u> | <u>3819</u> |
| 4. Types of Audit:   |             |             |             |
| Government   | 1484        | 1748        | 1823        |
| Private  | 1340        | 1681        | 1740        |
| Private for Government   | <u>95</u>   | <u>182</u>  | <u>169</u>  |
|  | <u>2919</u> | <u>3611</u> | <u>3732</u> |
| 5. Auditor's Opinion:  |             |             |             |
| Unqualified  | 2367        | 2942        | 3096        |
| Qualified  | 456         | 554         | 516         |
| Adverse  | 33          | 19          | 11          |
| Disclaimer of Opinion  | <u>48</u>   | <u>45</u>   | <u>42</u>   |
|  | <u>2904</u> | <u>3560</u> | <u>3665</u> |
| 6. Bank Staff Opinion of Borrower's Performance<br>(Any Serious Accountability Issues?): |             |             |             |
| Yes  | 168         | 210         | 143         |
| No   | 2543        | 3187        | 3389        |
| Unsure   | <u>192</u>  | <u>153</u>  | <u>154</u>  |
|  | <u>2903</u> | <u>3550</u> | <u>3686</u> |

Note: Details were not entered for some projects with respect to items 4, 5, and 6 above.  
ARCS now modified to ensure that all categories are entered for each project.