

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

ACCOUNTING AND AUDITING

May 7, 2003

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EXECUTIVE SUMMARY

After years of civil war in Lebanon, the Lebanese Government made vigorous efforts to align corporate financial reporting requirements with International Accounting Standards (IAS). In 1996, the Minister of Finance adopted IAS (with exceptions) as the national standards to be followed by all entities in the preparation of financial statements. High-quality financial reporting is essential in public interest entities in order that investors and customers can make informed decisions about these entities. While IAS are highly adapted to these public interest entities, they are generally more complicated than necessary for small- and medium-size enterprises, placing an excessive burden on them.

Despite the overall commendable progress in implementing international standards, there are still compliance gaps of varying degrees in both accounting and auditing practices. There is less gap in listed companies and banks; a greater gap appears in other companies with determinants based on size and who is performing the audit. These gaps stem primarily from shortcomings in professional education and training in Lebanon. When the Lebanese Association for Certified Public Accountants was established in 1994, all applicants, who sought license to practice, were certified without examination. More importantly, no enforcement mechanism exists to ensure IAS compliance, except in the banking sector.

Although many audit firms make effort to perform audits in accordance with International Standards on Auditing (ISA), quality of audits varies significantly. The Order on Auditing, issued by the Minister of Finance, does not cover regulation or supervision of the auditing profession and does not mention enforcement regulations or the monitoring of ISA compliance.

This report provides recommendations for an action plan, with particular focus on developing practical implementation guidelines; strengthening enforcement mechanisms; upgrading accounting curricula and increasing training arrangements and opportunities for practicing auditors; and establishing a system to perform quality control reviews of audit practices.

This report was prepared by a team from the World Bank on the basis of the findings of a diagnostic review carried out in Lebanon during June and September 2002. The staff team comprised M. Zubaidur Rahman (OPCFM), Samia Msadek (Manager, MNACS), Robert Bou Jaoude (MNACS), and Frédéric Gielen (ECSPS). The review was conducted through a participatory process involving various stakeholders in collaboration with the country authorities.

I. INTRODUCTION

1. This assessment of accounting and auditing practices in the Republic of Lebanon is part of a joint initiative of the World Bank and the International Monetary Fund (IMF) to prepare Reports on the Observance of Standards and Codes (ROSC). The assessment focuses on the strengths and weaknesses of the accounting and auditing environment that influence the quality of corporate financial reporting. International Accounting Standards (IAS)¹ and International Standards of Auditing (ISA) have served as benchmarks for the work, which involved a review of both mandatory requirements and actual practice.

2. Lebanon has a population of about four million. In the early 1970s, the middle-income country—with a vibrant economy led by private sector growth—served as a regional hub of finance and commerce. Beginning in the mid-70s, Lebanon was devastated by 15 years of war and 21 years of military occupation. The war left the economy in ruins, with real per capita income reduced by nearly two-thirds, due largely to the widespread destruction of infrastructure and productive assets. The war's disruption of capital investments and maintenance affected all economic sectors. By the end of the violence in late 1992, a massive reconstruction effort to rebuild the war-ravaged economy was the most urgent task facing the government.

3. There are 11 companies and 2 investment funds listed on the Beirut Stock Exchange (BSE) with a market capitalization of US\$1.4 billion as of April 2003, which represents less than 10 percent of gross domestic product. As of April 2003, there were 63 banks operating in the Lebanese banking system, of which the ten largest banks held some 75 percent of the total banking assets (US\$52 billion). There were 63 insurance companies, of which the top 15 companies accounted for 70-75 percent of the insurance business. In 2002, insurance companies in total issued approximately US\$400 million in premiums.

II. INSTITUTIONAL FRAMEWORK

A. Statutory Framework

4. **A number of laws, decrees, and ministerial orders govern Lebanese private sector accounting and auditing.** The Code of Commerce (1954) and its amendments deal with joint stock companies, limited liability companies, and partnerships; and set out the rules and regulations regarding auditor appointments and audits of financial statements. Banks are covered under the Code of Money and Credit, the Banking Law (1963), and related decrees, including Resolution No. 10/1 (1984) that defines the chart of accounts for banks and other financial institutions (except insurance companies).

5. **Ministerial Order No. 1/6258 (1996) requires that most companies present audited financial statements in conformity with IAS.** Although the Ministerial Order

¹ Within this report, International Accounting Standards refer to both International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board and the Standards issued by the Board of the International Accounting Standards Committee.

mandates the use of IAS, Law No. 27 (1980) still requires all commercial entities, except banks, to follow a unified chart of accounts. Since the tax authorities enforce the unified chart of accounts, the companies that prepare IAS-compliant financial statements also prepare a tax return in accordance with the accounting and reporting requirements in Law No. 27. Decree No. 8089 was issued in 1996 to clarify the legal requirements as to which companies are subject to annual audit:

- All holding, offshore, limited liability, and joint stock companies, regardless of type, size, and number and turnover of employees;²
- All branches of foreign companies operating in Lebanon; and
- All sole proprietorships and partnerships whose total number of employees exceeds 25 or that have annual turnover above LBP750 million (US\$500,000).³

6. **Small enterprises need not use IAS in preparing financial statements.** The size limits are much lower in Lebanon than in most industrialized countries. Thus, a small Lebanese enterprise currently faces, and will continue to face, significantly greater financial reporting burdens than small- and medium-size enterprises (SMEs) in most, if not all, industrialized countries.

7. **The use of IAS for legal entity financial statements may conflict with certain provisions within the Code of Commerce.** For example, the Code of Commerce sets out that the payment of so-called “fictitious dividend” is subject to criminal liability. This may pose a problem if the correction of a fundamental error or a change in accounting policy has to be applied retroactively under IAS.

8. **The Minister of Finance nominates members to the Higher Council of Accounting (HCA).** The HCA, headed by the Director General of the Ministry of Finance, plays an advisory role to the Minister on accounting and auditing matters. HCA membership comprises representatives from the main stakeholders in the accounting and auditing profession, including the president of the Lebanese Association of Certified Public Accountants (LACPA), head of the revenue department, chairman of the Banking Control Commission, representatives of the chamber of commerce and industry and of the banks’ association, and three practicing accountants selected by the Minister of Finance.

9. **General-purpose financial statements are often influenced by taxation rules and regulations.** The tax laws and decrees provide accounting requirements and the chart of accounts that companies must follow in determining taxable income. In order to satisfy the requirements of taxation authorities regarding the recognition of taxable revenues and deductible expenses, the preparers of general-purpose financial statements often tend to deviate from applicable financial reporting standards, preferring to follow

² Limited liability and joint stock companies must have at least three shareholders. All banks and insurance companies must be incorporated as joint stock companies.

³ The applicable exchange rate in April 2003 was 1,507 LBP (Lebanese Pounds) to 1 USD.

the tax rules. As a result, treatment of certain items in the general-purpose financial statements may be different from that which should apply under the IAS.

10. Companies are required to publish abridged versions of their balance sheets.

The abridged balance sheet, which is published in the official gazette, must be accompanied by the auditor's name and not necessarily the auditor's report. The publication of such abridged versions of the balance sheets may mislead readers because the published documents are not accompanied by the full financial statements, including explanatory notes.

11. According to the BSE directives, all listed companies are required to prepare legal entity and consolidated financial statements under IAS.

The applicable laws and decrees empower the BSE to set financial reporting requirements for the companies listed in Lebanon. According to the BSE requirements, all listed companies should file annual and semi-annual financial statements. The semi-annual financial statements need not be audited, but should undergo a limited review. Listed companies are required to publish balance sheets and income statements in local newspapers, although this requirement can be misleading because the published documents are not accompanied by the full financial statements, including explanatory notes. However, the full financial statements are available at the BSE.

12. The Banking Law requires all banks to follow accounting and auditing requirements set by the Banking Control Commission (BCC).

Although BCC offices are located at the Central Bank of Lebanon, it is an independent banking supervisory body. According to the applicable laws, banks must prepare and present annual and semi-annual legal entity and consolidated financial statements in accordance with the reporting requirements set by the BCC, in addition to various regulatory reports. These requirements are largely consistent with IAS, but with some significant deviations. For example, the allowance for loan losses is established in accordance with regulatory requirements rather than IAS 39, *Financial Instruments: Recognition and Measurement*; interest revenue recognition on bad loans differs from IAS 39 requirements; and the consolidation requirements differ significantly from those in IAS 27, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*. Circulars of the BCC are regularly updated toward closer conformity with IAS.

13. The bank auditor must be appointed at the shareholders' annual general meeting for a renewable period of three years.

The BCC has the authority to decide who can act as bank auditor, and it may ask a bank to change the auditor if the audit quality is not acceptable. The BCC has developed arrangements for maintaining an ongoing dialogue with banks' external auditors and for receiving useful information from them, in line with Basel Committee recommendations.⁴ There is no mechanism or regulation requiring nonlisted banks to disclose publicly the complete version of their financial statements; such disclosure is optional. Certain banks do publish their figures in

⁴ Basel Committee on Banking Supervision, *The Relationship between Banking Supervisors and Banks' External Auditors*, Publication No. 87, January 2002.

the local papers or as part of their annual reports, however these figures are not supported by the disclosure notes, consequently having reduced value.

14. **The insurance accounting and auditing regulatory framework is less advanced than that of the banking sector.** At present, insurance companies must prepare their annual financial statements in conformity with IAS, although there are no specific international accounting standards pertaining to insurance contract accounting. This causes problems. The Insurance Control Commission is preparing a new law aimed at enhancing the regulatory and supervisory framework, with specific accounting requirements applicable to insurance companies. These requirements will differ from IAS but will ensure consistency among insurance companies in the country. When the insurance sector is covered under IAS, the Insurance Control Commission plans to adopt IAS to serve as a basis for public, shareholder and supervisory purposes.

15. **The Act of Regularization of the Certified Public Accountants' Practice in Lebanon, which was issued in August 1994, provides the regulatory framework for the accountancy profession.** This Act authorizes the LACPA to regulate the professional activities of public accountants and auditors. Membership in LACPA includes qualified individual auditors and audit firms. The Act stipulates that an audit report may be issued with the signature of an individual auditor, an audit firm, or both. Individuals with foreign accounting qualifications (such as United States certified public accountants and United Kingdom chartered accountants) may obtain membership in the LACPA after passing examinations that cover Lebanese laws.

16. **According to a recent decree issued by the Ministry of Finance, some prequalified private sector audit firms may be engaged for the audit of public sector projects and entities.** The Court of Accounts is the agency authorized to perform public sector audits. Because of limited capacity of the Court of Accounts, the Minister of Finance issued an order requiring all state-owned entities to engage independent private sector auditors to perform the required annual external audit. For this purpose, the Ministry of Finance issued a list of prequalified audit firms.⁵ This new audit requirement was first applied in fiscal year 2001.

B. The Profession

17. **The Lebanese Association of Certified Public Accountants is the only legally recognized professional body for accountants in the country.** All auditors who practice in Lebanon are required to be members of LACPA. Some of its current members, who joined a predecessor association, were admitted into LACPA under a grandfathering clause. New members join under new entry requirements. There are about 1,700 registered individual members of the LACPA, of which about 250 are actively involved in auditing practice. Non-active members include retirees and individuals in corporate financial positions.

⁵ Prequalification criteria were mainly based on certain size thresholds so that only large audit firms were prequalified.

18. **Because of resource constraints, the LACPA is not able to carry out some important functions required to regulate the audit profession.** The LACPA secretariat is not properly staffed, and volunteer members carry out most functions. Although the LACPA is a member of the International Federation of Accountants (IFAC), it is not able to carry out some important functions that are required by IFAC, including supervision of members, and setting and implementing ethical standards and disciplinary procedures.

19. **The requirements for entry into the profession are becoming more rigorous.** After admitting all prior practitioners under the grandfathering clause, the LACPA began tightening requirements. Applicants must be 21 years of age, hold a university degree, and have at least three-years experience in an accounting firm, in addition to passing the three-part LACPA examination. Holders of recognized foreign professional qualifications are required to demonstrate familiarity with Lebanese law by passing the legal section of the examination in order to become full members.

20. **While professional accountants and auditors in public practice are required to follow the code of professional conduct, there is no mechanism to monitor and enforce this requirement.** The Act of Regularization of the Certified Public Accountants' Practice in Lebanon established the juridical process to be followed in case of ethical breach by any member and introduced related penalties. A disciplinary council consists of the association chairperson, the chair's deputy, and four additional members, of which two are elected by the general assembly. In practice, the LACPA initiates an investigation of misconduct or ethical breach only upon receipt of written complaints. There is no verification process or periodical audit of members by the association to monitor ethical misconduct or to discover violations of obligations. Nor is there any detailed and internationally accepted code of ethics, nor any effective mechanism to increase compliance or to raise awareness of ethical standards. The Code of Commerce defines some aspects of the relationship between the auditor and the client, but does not measure up to the requirements of the IFAC Code of Ethics for Professional Accountants.

21. **Professional indemnity insurance is not common in Lebanon.** While registered auditors are subject to civil liability, auditors are not required by law to take out professional indemnity insurance.

C. Professional Education and Training

22. **Private and public universities offer accounting education, but the interest of high-quality students in the profession remains low.** The quality of accounting education in the public university and most of the private universities suffers from the lack of modern accounting curricula. For example, accounting classes only superficially cover modern accounting information systems and IAS. Lately certain private universities have made an effort to introduce specialized accounting programs, instead of the traditional business administration degree pursued by most students. Interest in accounting programs has remained low and accounting graduates have had little effect on the profession at large.

23. **Passing the examination successfully depends on the quality of academic preparation at the university level.** The LACPA does not provide any preparatory or course material for the entrance examination. Undergraduate-level teaching in accounting and auditing focuses on elementary topics, and accounting courses account for only a single module within a more general curriculum. There are no independent courses teaching IAS and ISA. Although many faculty members have been educated in the United States or Europe, they lack appropriate textbooks and educational materials in areas covering international accounting and auditing standards. Certain universities that import accounting literature from the United States teach generally accepted accounting principles rather than IAS. The outdated curricula and lack of appropriate literature do not provide students with the necessary background for modern accounting and auditing, which should also include training in analytical thinking.

24. **The practical training arrangements for entry into the profession need to be strengthened.** The way the apprenticeship requirement is administered does not ensure proper or adequate practical knowledge about the auditor-trainee. To meet registration requirements, an applicant need only produce a National Social Security Fund certification indicating three years of employment by an auditing firm. The applicant's confirmation is not subject to any verification of work performed; in particular, there is no verification that the applicant has participated in any actual audit assignment during the apprenticeship period.

25. **There is no mandatory requirement on continuing professional education.** The LACPA regulations do not require the holders of auditing licenses to take training on a regular basis under any sort of continuing professional education. Under IFAC International Education Guideline No. 2, *Continuing Professional Education*, every practicing auditor should keep pace with new developments in auditing and accounting and complete at least 30 hours of continuing professional education per year. The association does organize annual seminars where international experts present the latest development in the accounting profession and changes to the IAS. Attendance at such seminars will become mandatory beginning September 2004.

26. **Professionals working in small accounting firms or sole practitioners face difficulties in keeping up with accounting and auditing developments.** These professionals are constantly struggling to keep their client base and earn enough income to secure a decent living for themselves and their families. They cannot afford expensive and time-consuming training programs or materials. Their lack of access to international experience is negatively affecting the application of IAS and the quality of auditing in the country. It is expected that the introduction of continuing professional education programs would contribute to bridging the gap in this respect.

D. Setting Accounting and Auditing Standards

27. **The Ministry of Finance has established a mechanism for adoption of IAS as the national accounting standards.** Ministerial Order No. 1/6258, dated August 21, 1996, and issued by the Minister of Finance, requires that financial statements of all

companies in the real sector should be prepared in accordance with IAS. On an annual basis, a list of the titles of applicable IAS is published in the Official Gazette. The Order No. 1/6258 states that the official English version should be referred to in resolving any instances of differing interpretation. Neither the LACPA or any other authority has issued an official Arabic translation of the IAS, however an Arabic print version that is in use in other Arab countries is readily available in Lebanon.

28. International Standards on Auditing are applicable for the audit of listed companies and banks. The rules of the Beirut Stock Exchange and the Banking Control Commission require that the financial statements of all listed companies and all local banks should be audited in accordance with ISA.

29. There is no provision in the current legislation regarding the standards to be followed by auditors, but this gap will soon be closed. The current legal framework for the country does not include any regulation or identification of the standards to be followed when auditing financial statements other than for banks and listed companies. The Minister of Finance is presently drafting a Ministerial Order to require ISA to be followed by all auditors. In the meantime, a recent order (Ministerial Order No. 742, dated April 15, 2002) introduced ISA No. 700, *The Auditor's Report on Financial Statements*, as the official format to be followed for audit reports in Lebanon.

E. Enforcing Accounting and Auditing Standards

30. The Beirut Stock Exchange Authority outsources the review of listed companies annual financial statements. For this review outsourcing, the BSE hires a major audit firm in the country, rather than have them performed by an internal committee. In addition to ensuring timely filing of financial statements, the review is intended to verify whether the audit reports and financial statements are presented in accordance with ISA and IAS, respectively. External independent auditors that are engaged by the BSE perform random verification on the prepared financial statements and report any deviation from IAS. Should the review process reveal divergences, the company is asked to rectify errors and restate its financial statements within a defined period of time. If the company declines to comply, the BSE Authority has the power to suspend trading or even delist the violating company. But the BSE lacks the necessary authority to penalize or blacklist financial statement preparers and auditors of listed companies for noncompliance with the financial reporting requirements. The Stock Exchange does not publish an annual report presenting the results of the reviews, which, if they did, would help to build public trust. Also, there is no securities market authority (e.g., no Securities and Exchange Commission) in Lebanon.

31. The Banking Control Commission monitors compliance with the accounting and disclosure requirements. Specific measures are taken by the BCC to enforce the accounting and reporting requirements, including desk reviews and field meetings with the auditors. The BCC has the authority to require additional details about the financial statements to ensure compliance with the Central Bank circulars and directives. Lately, as part of efforts to fight money laundering, the Central Bank imposed new obligations on

the bank's auditors who are now required to report any unidentified sources of funds within the system.

32. **Public accountants and auditors are not subject to performance review by any regulatory body.** The performance of an auditor is not subject to outside review. However, in bank audits, when BCC's on-site supervision identified certain shortcomings in the external auditor's work, the auditor was replaced as a result of the BCC "moral suasion." Observers noted that many small- and medium-size audit firms agree to clients' requests to circumvent the rules in an effort not to lose them to other firms or auditors. These smaller firms have difficulty in finding funds to invest in either upgrading skills or recruiting qualified professional staff.

III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

33. **Neither the Ministry of Finance nor any other organization has the authority to enforce IAS, except with listed companies and banks.** Although adopting IAS was an important step toward upgrading the financial reporting of Lebanese enterprises, there continues to be a significant compliance gap due to the lack of enforcement and monitoring mechanisms and to a capacity shortfall. In addition, there is no mechanism for imposing sanctions on preparers and auditors who may not comply with accounting and auditing standards. The lack of knowledge and guidelines on the implementation of accounting standards has had a direct effect on the quality of financial statements. The latest versions of the standards and the appropriate application manuals should be made available at affordable prices to all practitioners.

34. **Companies and their auditors face a number of practical difficulties in implementing IAS.** Discussions with representatives of auditors suggested some problems with IAS implementation. Most of these problems arise from the lack of adequate IAS expertise among company accountants, who find it difficult to prepare financial statements in accordance with the IAS requirements.

35. **In order to assess the compliance gap, the ROSC team selected 7 companies listed on the BSE, 5 banks, and 6 nonlisted companies from which to review a sample of financial statements.** The ROSC team could review the financial statements of nonlisted companies made available only on a voluntary basis. Financial statements of nonlisted companies are not readily available, as there is no regulation requiring disclosure of such reports. The ROSC team could not obtain any financial statements prepared by insurance companies.

36. **While the quality of IAS financial statements prepared by banks and listed companies was relatively good, there were certain variations in the level of compliance with IAS.** The related audit reports were not qualified, which may be based on the fact that the auditors considered these issues were not a material departure from IAS. Examples of deficiencies found in the examination of financial statements relative to IAS included:

- **Consolidated financial statements (IAS 27, SIC 12).** One of the banks in the sample did not consolidate a wholly owned special-purpose entity that owns a 23 percent equity stake in another group of companies. It accounted for the special-purpose entity under equity accounting. This exclusion is not permitted in IAS 27 or Standing Interpretations Committee (SIC) 12, *Consolidation—Special Purpose Entities*. This is a good example of the problems that a reader of the financial statements faces, as the 23 percent investment and any debt in the special-purpose entity's books are not reported in the consolidated financial statements.
- **Presentation of the cash flow statement (IAS 7).** The sampled banks use differing definitions of cash and cash equivalents, which make comparison among banks difficult. Also, some sampled banks erroneously classified operating cash flows as investing or financing cash flows (for example, loans and advances as investing cash flows rather than operating cash flows). Many sampled companies did not disclose payments and receipts for interest and income taxes separately, as required by IAS 7, *Cash Flow Statements*.
- **Business combinations (IAS 22).** In several banks, the amortization of goodwill appeared to be determined by the BCC rather than by the useful life of that goodwill.
- **Depreciation of property, plant and equipment (IAS 16).** All sampled companies appeared to use tax rules to determine accounting depreciation, which may not comply with IAS 16, *Property, Plant, and Equipment*.
- **Deferred taxes (IAS 12, Income taxes).** None of the sampled companies provided for deferred taxes on temporary differences. This is a good example of the problems that a reader of the financial statements faces, since tax liability or asset may be hidden. Alternatively, it may indicate that taxation considerations are influencing the application of accounting rules, including IAS.
- **Retirement benefit costs (IAS 19).** In Lebanon, the end of service indemnity is calculated based on the last monthly salary multiplied by the years of service. The employer regularly makes contributions amounting to 8.5 percent of current salaries to the National Social Security Fund (NSSF). Upon payment of the defined benefit by the NSSF to the employee, the employer has to pay the difference between the defined benefit and the amount contributed already by the employer. This scheme is in substance a defined benefit plan. While sampled companies recognized the existing difference based on current salaries, the amounts recognized may not comply with IAS 19, *Employment Benefits*, because they are not based on an actuarial computation.
- **Related party transactions (IAS 24, IAS 30).** Most sampled companies did not disclose related party transactions although some indicated the existence of related party relationships. Therefore, a reader of financial statements may

not be able to form a view about the effects of related party relationships on a reporting enterprise.

37. **The review of financial statements prepared by nonlisted companies revealed major shortcomings in actual application of the IAS.** In many cases financial statements prepared under IAS were completely misleading. Divergences between the IAS, now also the national standards, and actual practice include:

- **Revenue recognition (IAS 18).** In certain cases, when dealing with government contracts, revenues are reported only when received rather than when earned, as required under accrual accounting.
- **Disclosures.** Generally companies avoid full disclosure of information in the published financial statements, thus ignoring the disclosure requirements set by the applicable accounting standards.
- **Assets pledged as collateral.** It is a common practice not to disclose assets in the financial statements that have been pledged for securing loans.
- **Statement of changes in equity (IAS 1).** Contrary to the applicable standard, the financial statements of many companies do not include the statement of changes in equity.
- **Inventory valuation (IAS 2).** Few companies follow all the requirements related to measuring and disclosing inventory between the lower of cost or market value. It is common to understate or not to apply the provision at all for obsolete and slow-moving inventory.

IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

38. **In spite of the lack of requirements to apply ISA except in banks and listed companies, audit firms generally refer to ISA in the auditor's report.** Translations of ISA 700 and samples of the different ISA report formats were published in the official gazette. However, as in the case of the IAS, the ISA are not widely available. And, mainly due to the cost, most audit practitioners do not have access to ISA-based audit practice manuals. The degree of compliance with the ISA varies among large and small firms. In general, the larger audit firms are better able to provide access to documentation and quality auditing services; but even in large firms, compliance with the standards is not always ensured.

39. **The profession needs to make increased efforts to improve the quality of auditing practices that go beyond what is required for local tax declarations.** Most external auditors in Lebanon are concerned about tax accounting, with the objective of reducing their client's tax liability. Tax accounting concerns often take precedence over ensuring the soundness of general-purpose financial reporting. Management of companies often places greater emphasis on the submission of statistical returns and the determination of taxation liabilities and less emphasis on IAS-based financial statements. It is clear that many audits are carried out to a high standard by both local member firms

of major international networks. However, in certain cases the auditor and client make decisions about the accounting treatments and prepare the appropriate disclosures for reporting in the financial statements with an eye primarily to ensuring favorable tax outcomes. Such practices should be avoided because they do not serve the interests of the public or the profession, and they are not compatible with ISA and the IFAC Code of Ethics for Professional Accountants. Failure to understand and apply the ISA requirements results in noncompliance or partial compliance with many of the applicable auditing standards. This is especially a problem for many auditors who are not part of the international accounting firm networks.

40. **One-person firms that cannot offer adequate audit planning, quality control, or supervision carry out audits of many smaller companies and businesses.** Over approximately 85 percent of audit offices are one-person firms or employ only one or two junior staff. In such cases, audit planning is usually limited and quality control procedures are nonexistent, often resulting in the absence of audit working papers.

V. PERCEPTIONS ON THE QUALITY OF FINANCIAL REPORTING

41. **Currently there is little demand from capital market users for financial information.** Interviews and discussions with various parties, including financial analysts and representatives of foreign and local banks, reveal serious concerns about the weakness of the enforcement mechanism that facilitates noncompliance with the IAS and ISA. Local banks base their lending decisions on other information that they obtain, in addition to the financial statements. There is little pressure for improvements in the quality of financial reporting from stock market traders, given the small size of the BSE. The banks exercise little pressure to improve the preparation and audit of financial statements, because most banks do not rely on financial statements, but instead apply other procedures for obtaining reliable information about their corporate borrowers. . Most external users of financial statements indicated that they depend mainly on personal contacts within the company to gather reliable information.

VI. POLICY RECOMMENDATIONS

42. The policy recommendations presented in this section are based on the findings of the review of accounting and auditing practices, and include valuable inputs received from various stakeholders interviewed by World Bank staff during the due diligence exercise. It is expected that these policy recommendations will be used as inputs for preparing and implementing an action plan for accountancy reform in the Republic of Lebanon.

43. **Amend or legislate laws dealing with accounting, auditing, corporate financial reporting, and the accountancy profession in the country.** The Code of Commerce, the respective ministerial orders, and other relevant laws should be fine-tuned; and other appropriate actions should be taken to ensure that IAS and ISA requirements apply to all public interest entities. This might necessitate the enactment of a new Financial Reporting and Accountancy Profession Act (hereafter referred to as the

Financial Reporting Law.) The provisions on accounting, auditing, and financial reporting in the other laws, including the Code of Commerce, should be amended to include cross-reference to the relevant provisions of the Financial Reporting Law. Important features of the new law should include the following:

- IAS and related interpretations issued by the International Accounting Standards Board (IASB) should be mandatory for the financial statements of all public interest entities. The audit of financial statements prepared by public interest entities should be carried out in accordance with the ISA and other related pronouncements issued by the IFAC.
- Public interest entities may be defined as such by the nature of their business, their size, their number of employees, or their corporate status by virtue of their range of stakeholders. Examples of public interest entities might include banks, insurance companies, investment funds, pension funds, listed companies, and large enterprises.
- The Financial Reporting Law should relax the requirement for full IAS financial statements for SMEs. For example, the legal requirements could provide SMEs with a reporting framework more adapted to their size.

44. **Strongly enforce the publication and filing of legal entity and consolidated financial statements.** The law should be amended and enforcement mechanisms reviewed to cover the following issues:

- Legal entity and consolidated financial statements of public interest entities should be readily and timely, preferably available in electronic format.
- Publication of abridged financial statements (in newspapers and on websites) should be avoided or authorized only if:
 - abridged financial statements are appropriately identified as being derived from fully audited financial statements, for example, with a disclaimer that says “Summarized Financial Information Prepared from the Audited Financial Statements for the Year Ended December 31, [2002]”;
 - auditor’s report accompanying the abridged financial statements is in accordance with ISA 800, *The Auditor’s Report on Special Purpose Audit Engagements*, and which, among other things, includes the statement, “For a better understanding of the Company’s financial position and the results of its operations for the period and of the scope of our audit, the summarized financial statements should be read in conjunction with the financial statements from which the summarized financial statements were derived and our audit report thereon”; and
 - audited financial statements are readily available to all interested parties and the publication states where the fully audited financial statements can be obtained.

- The publication of erroneous and misleading annual reports should be subject to severe penalties, which may include administrative penalties, civil liability, and—in the event of fraud—criminal liability.

45. **Redefine the role of the Higher Council of Accounting.** The government may consider redefining the role of this Council as an accounting and auditing oversight body. Such a body could then be charged with the review of activities of practicing auditors, quality of education and training, and efficiency and effectiveness of the institutional framework in supporting high-quality financial reporting. With regard to the users of audited financial statements, the oversight body should assess whether the auditing profession is serving their interests and those of the wider public appropriately. In turn, it would publish assessment reports that would bring to light the problems and prospects of the auditing profession. Moreover, the body should advise the LACPA, educational institutions, and statutory regulators on actions needed to ensure that education and training arrangements, and monitoring and enforcement mechanisms are consistent with international best practice.

46. **Reform the Higher Council on Accounting with the following three committees:**

- ***Accounting and Auditing Standards Committee.*** The function of the Accounting and Auditing Standards Committee will be to adopt the application of IAS and ISA with respect to the public interest entities. In addition, this Committee will prepare and enact implementation guidelines on practical application of IAS and ISA in Lebanon. When an exposure draft on a new standard is issued by the IASB and the IFAC, the Accounting and Auditing Standards Committee will disseminate the exposure draft within the country, will collect comments, and will, at the end of the comment period, summarize the comments for transmitting to the IASB/IFAC. The Committee accepts and disseminates the final version of the standard, when approved and issued by the IASB/IFAC. In addition, the Committee should be entrusted with the responsibility of developing accounting requirements for SMEs.
- ***Financial Reporting Monitoring Committee.*** The purpose of the Financial Reporting Monitoring Committee is to analyze and identify noncompliance with the applicable accounting and financial reporting requirements; the findings will be forwarded to the HCA Management Board along with recommendations on the nature of sanctions to be imposed on the preparers and auditors of the financial statements. The Management Board will make a final decision on sanctions and take necessary steps for their implementation. The Financial Reporting Monitoring Committee should develop strong capacity to conduct in-depth review of public interest entities financial statements in order to determine the extent of compliance with the standards and regulations—not only in appearance, but also in substance. The analyst group that will be responsible for conducting the review may consist of a mixture of full-time and part-time experts engaged by the HCA. The policies

and procedures of conducting monitoring activities will be developed by the Committee and approved by the HCA Management Board.

- ***Auditors' Practice Review Committee.*** The Auditors' Practice Review Committee will maintain a list of qualified auditors and audit firms that will have permission to audit the public interest entities. These auditors and audit firms, who are members of the LACPA, will be subject to practice review by the LACPA under the oversight of the Committee in order to analyze and identify noncompliance with the applicable auditing standards and code of professional ethics. When warranted, the findings from this review will be forwarded to the HCA Management Board along with recommendations on the nature of sanctions to be imposed on the auditors. The Management Board will make a final decision on sanctions and take necessary steps for their implementation. The practice review system should include the evaluation of quality assurance arrangements in an audit firm and the examination of working papers with respect to selected audit engagements of the same audit firm. Moreover, the Committee should oversee the conduct of investigations by the LACPA whenever credible complaints are received against any auditor or audit firm with regard to the observance of auditing standards and code of professional ethics. The Auditor's Practice Review Committee should develop strong capacity for carrying out these functions.

47. **Upgrade the procedure of licensing accountants and auditors in public practice.** The procedure for obtaining license to practice as a professional accountant/auditor needs to be improved. In order to obtain the professional accounting qualification, an individual should meet the minimum requirements based on IFAC pronouncements in this regard. The procedures for qualifying as a certified public accountant should be changed to attract the meritorious university graduates to the profession. The curriculum and system of qualification examinations need to be improved in conformity with IFAC-proposed International Education Standard for Professional Accountants. Moreover, arrangements need to be made so that the LACPA regularly monitors the quality of practical training provided by authorized training providers (audit firms) to the trainee auditors.

48. **Ensure effective continuing professional education and development of the accountants and auditors in public practice.** The requirements on continuing professional education and development of the qualified members should be improved in line with the IFAC-proposed International Education Guideline for Professional Accountants. According to the Code of Ethics for Professional Accountants, it is the professional duty of the qualified accountant/auditor to maintain and improve professional competence continually. The LACPA should arrange delivery of high-quality training programs and facilitate access to universities and other training providers, which will enable its members to effectively meet the requirements on continuing professional education and development. Arrangements need to ensure that the LACPA members meet these requirements.

49. **Strengthen the capacity of the LACPA by establishing twinning arrangement with a professional accountancy body.** In view of the recent worldwide developments with regard to the regulation of accountancy profession and reform of the role of professional bodies, it is necessary to take immediate steps for restructuring and strengthening the governance structure of the LACPA. Moreover, there is an urgent need for improving the mechanism of day-to-day functioning of the LACPA. In this regard, an arrangement needs to be made for long-term twinning of the LACPA and a developed professional accountancy body, whereby knowledge transfer will be more easily facilitated in Lebanon.

50. **Take steps for improving curriculum and teaching in accounting programs of universities and colleges.** In order to ensure that a minimum quality standard is maintained in teaching accounting and auditing courses in all universities and colleges across the country, a centrally coordinated initiative is necessary for curriculum development and training the trainers. Arrangements are necessary to review and update the accounting curriculum in order that international accounting and auditing standards are incorporated and practical-oriented teaching at the undergraduate level is included. The ethical dimensions of business management, corporate finance, accounting and auditing should be taught with case studies in the undergraduate programs of business schools/commerce faculties. A training-the-trainer program will enhance the capacity of higher educational institutions to teach accounting and auditing courses with international components.

51. **Provide meaningful theoretical and practical training in International Accounting Standards.** The staff of the proposed Financial Reporting Monitoring Committee, the Banking Control Commission, and other regulators require meaningful theoretical and practical training in IAS in order to enforce accounting standards as recommended.

ABBREVIATIONS AND ACRONYMS

BCC	Banking Control Commission
BSE	Beirut Stock Exchange
HCA	Higher Council of Accounting
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
ISA	International Standards of Auditing
LACPA	Lebanese Association of Certified Public Accountants
NSSF	National Social Security Fund
ROSC	Reports on the Observance of Standards and Codes
SME	Small- and medium-size enterprise