1. Background

A World Bank team including Jarett Decker, Head of the Centre for Financial Reporting Reform (CFRR) (GGOSC), Bonnie Sirois, Senior Financial Management Specialist (GGOSC), and Andreas Grimminger, Corporate Governance Consultant (GFSCN), visited Kabul from Apr 28 – May 2, 2018. Syed Waseem Abbas Kazmi, Sr. Financial Management Specialist (GGOAP) joined the mission from the Kabul office and Subika Farazi, Financial Sector Specialist, GFCSN (TTL), Ahmed Rostom, Senior Financial Sector Specialist, GFSCN and Pasquale Di Benedetta, Senior Financial Sector Specialist, GFCFN, provided support remotely from DC.

The main objectives of the mission were to (1) Scope out a Corporate Governance Reforms Diagnostic Study for Afghanistan and gain a general understanding of the training needs of SOEs in the areas of corporate governance and IFRS compliant financial reporting in support of implementation of the Fiscal Performance Improvement Project (FPIP) and (2) Scope Da Afghanistan Bank’s training needs for preparing IFRS compliant financial statements under the Financial Sector Rapid Response Project.

The mission objectives are aligned with ongoing efforts for supporting economic stabilization, donor confidence, and growth in Afghanistan. It is also in response to Government as well as donors’ priorities to strengthen financial transparency and internal controls of key institutions in the country to support prospects for sustainable growth.

In support of the mission objectives, the team met with Mr. Mohammad Aqa, Deputy Minister Admin MOF, Mr. Mujtaba Shams, Director General Enterprises MOF, Mr. Shoaib Rahim, Director General DAB, CPA Afghanistan, and conducted two separate workshops with more than 60 participants from MOF, SOEs and SOCs, DAB, and the Bankers Association.

2. Mission Outcomes and Deliverables:

Two separate workshops were conducted during the mission. Participant lists are included in Appendixes A and B.

SOE/SOC Workshop: This workshop convened participants from the MoF and various SOEs and SOCs. The objective of the workshop was to (1) convey basic principles of corporate governance and financial reporting relative to SOEs and SOCs, and (2) to gather information from the group on the corporate governance and financial reporting principles in place in the country, as well as the actual practices being followed.

Workshop with Da Afghanistan Bank: This workshop convened participants from the central bank to (1) convey common IFRS implementation challenges and considerations in transitioning to IFRS, and (2) gather information from the group on their level of IFRS knowledge, past IFRS trainings, extent of IFRS application currently being applied in practice by both the central bank and banking institutions, extent of scrutiny applied to financial statements of banks, and perceived challenges.

The feedback and discussion from these workshops is incorporated into the mission findings contained in Section 3 below.

3. Mission Findings

Information collected during the mission and otherwise available suggests that accounting and reporting practices in the state-owned and financial sectors are so poor that levels of indebtedness and fiscal and stability risks as well as potential fiscal drain cannot be adequately assessed or addressed. Thus,
improving the reliability of financial information is important for targeting further development work and achieving development goals. It should be stressed that Afghanistan does not currently have capacity for broad-based application of international good practices in financial transparency and reporting, so interventions must be targeted towards areas of greatest risk, with due regard for limitations in available capacity. The section below provides a detailed summary of the key findings for the three areas explored by the team; including (i) Gaps in accounting and reporting by state owned enterprises and corporations, (ii) Active plans by the banking sector to adopt IFRS and (iii) Level of capacity within the accounting profession.

(i) Gaps in accounting and reporting by state owned enterprises and corporations

1. The Government has identified 36 State Owned Enterprises (SOEs) and 17 State Owned Corporations (SOCs). Of the 36 SOEs, an estimated 4 or 5 are reported to operate in accordance with their core business purpose. The remainder have ceased core business operations but continue to hold and lease out property and maintain staff on payroll.

2. Each SOE is supervised by a High Council, sometimes also called Supreme Council (there are translation issues). It is composed of 5 to 7 members, chaired by the Minister of Finance and also comprising members from the relevant line ministries, ministry of the economy, the presidency and other members specified by the Articles of Association of the respective SOE.

3. The MoF has submitted a proposal for the establishment of a Supervisory Board for SOEs to the cabinet. Approval is pending. The proposal would establish supervisory boards composed of independent experts and not officials from the ministries. According to our understanding, the High Council would be transformed into the Shareholder Assembly for the respective SOEs.

4. There are two draft laws for SOEs and mixed enterprises or SOCs. According to the Deputy Minister for Administration of the MoF, there was previously no mixed enterprise law, but pending reforms to the Company Law—which currently applies to SOCs—create need for a new, specific SOC law. The MoF is working with the IMF on the draft laws because their reform is a structural benchmark in the IMF program with Afghanistan. The legal advisor to the Minister of Finance was encouraged to learn that the World Bank is coordinating with the IMF in the legal reform review.

5. Representatives from SOEs and SOCs mentioned the problem of multiple principals, i.e. being subject to competing directives from the MoF, relevant line ministries and the President’s office. As mentioned in our workshop, the new SOE law is meant to clarify the roles of line ministries. We should seek clarification on this issue.

6. According to a number of workshop participants, SOEs and SOCs are suffering from a lack of a level playing field with their privately-owned competitors. A burdensome procurement law does not allow them to compete with private competitors, in particular importers, according to multiple participants. On the other hand, a Presidential Decree requiring government purchases from SOEs or SOCs as long as they are no more that 20% over the price of private competitors was mentioned by workshop participants. We were unable to verify the existence of such a decree.

7. The financial reporting requirements for SOEs are prescribed under The State-Owned Enterprises Law, 1990. Accounting for SOEs needs to comply with the standard accounting plan and accounting forms approved by the MOF and follow the General Rules for Accounting and Reporting. The MOF
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maintains an accounting manual for SOEs, and a standard Chart of Accounts for SOEs has recently been updated. Line ministries regulate the accounting and reporting for enterprises. A progress report on production and financial activities and annual balance sheet are required to be forwarded to the relevant ministry, Ministry of Finance and to the bank which maintains transactions with the SOE. The financial year of SOEs corresponds to the Solar year.

8. Some of the common issues identified in financial statements of SOEs include:
   i) No underlying IT systems – accounting records are generally handwritten or Excel spreadsheets are used;
   ii) Financial reports are sometimes handwritten;
   iii) General purpose financial statements with footnote disclosures are not produced; instead the form of reporting follows a template containing a balance sheet and income statement
   iv) No defined accounting standards and policies are prescribed – each SOE follows its own policies which are generally modified cash basis. Accounting policies are not documented and not consistent among the various SOEs;
   v) Accounting policies used are not stated and;
   vi) The financial information is generally unaudited.

9. The Supreme Audit Office (SAO) is legally required to audit SOEs, but audits are carried out ad-hoc rather than on a systematic basis. The SOA completes compliance audits rather than financial audits. Furthermore, the Law on State Owned Enterprises requires annual external audits of SOE financial statements, but capacity constraints have prevented these audits from being conducted. Currently, 5 (five) SOEs are undergoing an initial financial audit by an independent external auditor.

10. Current work and planned developments include updating the current reporting templates for SOEs, planning to install a database system to submit financial reports, and a planned workshop on the new Chart of Accounts.

11. The financial and operational oversight role of the MoF (which houses the SOE Department) are spelled out in Article 79 of the Tassady Law. This includes reviewing the financial operations of SOEs based on quarterly progress reports and annual balance sheets. Owing to lack of capacity, oversight of SOEs is inadequate. Confusion exists with regard to the authority of DG Enterprise (MOF) over SOCs, as the latter have their own oversight governance bodies and report to their respective line ministries. The audited financial statements of SOEs and SOCs are not published and do not disclose contingent liabilities, guarantees, and other fiscal risks. MoF also has not prepared and published a consolidated report on the financial performance of the SOEs and SOCs.

12. The Corporation and Limited Liability Companies Law mandates the issuance of annual financial reports for SOCs, but actual compliance and quality of information do not match legal requirements. Corporations must deliver financial statements for the previous fiscal year to all shareholders not less than 15 days prior to Annual Meeting of the Shareholders. This report must include the balance sheet and profit and loss statement for operations. The law refers to International Accounting Standards, however, no further policies or other guidelines are available and SOCs tend to follow the accounting guidelines for SOEs in the absence of other guidance. Reporting compliance is only partial and timeliness and availability of information, as in the case of SOEs, remains a problem. Moreover, the fiscal relationship between SOCs and the GOA has been unclear in terms of subsidies, payment arrears and payment of taxes. In fact, the SOE Department does not have direct control over SOCs and does not receive regular information from these state corporations.
13. Generally speaking, accounting capacity within SOCs is stronger than within SOEs. Some SOCs report to have internal accounting manuals and use IFMIS systems; however many have paper or Excel based systems or use Quickbooks bookkeeping software. Seven SOCs have undergone financial audits by an independent external auditor.

(ii) Active plans by the banking sector to adopt IFRS

14. The Banking sector includes 3 state-owned banks, 3 foreign banks, and 7 domestic commercial banks. Representatives from DAB expressed a fair understanding of IFRS and many individuals communicated that they had undergone recent trainings and were familiar with IFRS theory. However, they expressed a need for guidance in the practical application and implementation of IFRS. An IFRS gap analysis for DAB is currently underway.

15. Based on DAB review of annual audited financial statements submitted by the banks, the financial statements are not prepared in full accordance with IFRS. Commercial banks are reported to have a greater level of compliance with IFRS than state-owned banks, but no IFRS gap analyses have been completed for the banks, nor have IFRS transition plans been completed. Specific challenges include application of IFRS 9, consideration of Islamic Finance in applying IFRS, a lack of valuation and actuarial specialists in the country, loan loss provisioning, and disclosure of information requiring judgements and estimates.

16. DAB reviews the audited financial statements of the banks in only a perfunctory manner and does not assess the banks’ compliance with IFRS or scrutinize the audit report in a meaningful way. Communication between the banking supervisor and auditors is limited and is normally limited to submission of the audited financial statements and management letter.

17. The Banking Law provides that DAB may demand auditor workpapers and require termination of an auditor. However, DAB has not exercised this power, nor does it appear to have any power to sanction auditors for misconduct, beyond terminating their right to audit banks.

18. All banks are reported to use IT systems; however, no IT audits are completed and this skill is not available in the country. Forensic audit is likewise not available.

(iii) Level of capacity within the accounting profession.

19. Four international audit firms have a presence in Afghanistan, including Deloitte, PWC, KPMG, and Grant Thornton. Approximately 80 smaller audit firms maintain offices in Afghanistan. Approximately 95% of all audit firms are branches with main offices in Pakistan. These firms purportedly have a strong profit motivation, take no interest in developing the profession within Afghanistan and take no role in improving financial reporting or audit quality.

20. Applicable audit standards to be followed in Afghanistan are not defined in laws, regulations, statutes or other authoritative guidance.

21. There are currently no public oversight arrangements applicable to Public Interest Entities (PIEs) to monitor compliance of financial statements with accounting standards or to review the quality of the external audits being conducted by auditors of PIEs. The fledgling CPA Afghanistan has initiatives underway in these areas, however these will not be operational in the near term.
22. A law to establish CPA Afghanistan as the Professional Accountancy Organization has recently been passed in parliament. There is an extreme shortage of qualified and competent accountants in Afghanistan, but CPA Afghanistan has several initiatives underway including:

   a. ACCA scholarship program – approximately 40 students have graduated and approximately 1,400 are currently enrolled in the program. Of this number, approximately 200 are women;
   b. A concept for an Accounting Technician qualification is being developed;
   c. MOUs with ACCA, ICAEW and CPA Jordan to provide assistance in developing the organization;
   d. The MOU with ACCA includes a partnership to develop a quality assurance review function over auditors;
   e. Working with Kabul University to develop a Faculty for Accounting in partnership with the Islamic University of Malaysia;
   f. Licensing of auditors in Afghanistan;

4. Next Steps

As next steps, the team will

(1) Proceed with drafting the outline for a diagnostic study of corporate governance and financial reporting over public enterprises which will include a roadmap for strengthening these areas in support of the Fiscal Performance Improvement Support Project, and

(2) Developing a concept note for recommended actions to strengthen financial reporting of the banking sector in support of the Financial Sector Rapid Response Project.

(3) In addition, the team expects to receive a “wish list” from CPA Afghanistan of requested items for technical support and other possible assistance.

5. Key Recommendations

A summary of key recommendations is included below.

1. Ensure current legal reforms to SOE and SOC framework take into account corporate governance and financial reporting aspects that are adequate for current stage of development of Afghan SOEs and SCOs and the capacity of the MoF;

2. To the extent possible, professionalize the Supervisory Boards of SOEs (currently called High Councils) and staff them with experts from relevant fields rather than ministry officials;

3. Assess the capacity of the DG SOEs & SCOs of the MoF to adequately monitor the portfolio of companies and devise strategies to strengthen it or build a separate ownership unit;

4. Establish a reporting system that allows the MoF to collect relevant information from the enterprises under its oversight;

5. Rationalize and consolidate the current portfolio of SOEs to concentrate resources on viable and operating entities;

6. Establish an accounting and auditing standard setting body;
7. Move forward with the strategy developed by CPA Afghanistan to develop and regulate the accounting and auditing profession in the country;

8. Structure IFRS Transition planning at both the sector and individual entity levels, with priorities based on risk analysis. The transition planning should begin with an IFRS gap analysis to assess the starting point for the transition;
   a. Prepare sector level IFRS transition plans that include feasible transitions timeframes, identify the capacity building activities required to support IFRS implementation and the level of resources that will be needed to support the transition process. Consideration of a phased approach that takes account of the different stages of IFRS readiness of individual entities within each sector is likely required;
   b. Require each individual PIE within their sector to prepare and submit an IFRS transition plan. These plans should specifically include the process for the establishment of an IFRS opening balance sheet in compliance with IFRS 1; and
   c. Use the individual entity IFRS transition plans to monitor the sectors’ progress towards transition as part of their regular oversight and supervision processes.

9. There are significant capacity building required for both preparers and regulators. This can be broadly categorized into three areas:
   a. IFRS capacity building for preparers. This is required to put them in a position to be able to control the financial statement preparation process without undue reliance on their auditors and advisors. It will need to cover practical IFRS implementation issues; and
   b. Training for supervisory staff at the regulators. This should cover i) IFRS concepts, principles, and practical implementation ii) the different types of audit opinions issued and the implications of qualified audit opinions and iii) the differences between financial reporting for prudential reporting purposes and IFRS general purpose financial reporting iv) communications between supervisors and auditors and enforcement measures which may be exercised.
   c. Education and shared learning programs for key decision makers (i.e. senior regulators, policy decision makers, directors and senior management in the preparers). This should cover i) the reasons for and benefits from IFRS adoption, ii) the significant differences between current accounting practices and IFRS Standards, iii) the difference between IFRS general purpose financial reporting and financial reporting for regulatory purposes, iv) the linkages between IFRS financial reporting and improved corporate governance v) the role of external audit and the importance of the auditor’s independence and vi) the implications in terms of resources required for capacity building and other costs of IFRS transition.