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Accounting in a Country: The Case of Pakistan

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LAHORE UNIVERSITY OF
MANAGEMENT SCIENCES

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The Center for Management and Economic Research (CMER) is a research center of LUMS based in the Department of Economics. The mission of CMER is to stimulate, coordinate, and conduct research on major economic and management issues facing Pakistan and the region. CMER research and dissemination roles are structured around four inter-related activities: research output in the form of working papers; cases and research monographs; creation of data resources; and organization of seminars and conferences. LUMS-Citigroup initiative on corporate governance in Pakistan is a major on-going project of CMER.

Accounting in a Country: The Case of Pakistan

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I. Introduction

Recent advances in information and financial technology have pushed the ideas of global business strategy and alliances into center stage. The level of understanding of outsiders regarding how business with-in a particular country is conducted could determine the difference between a successful or a failed outcome - more so, if the country is an emerging economy such as Pakistan. One integral part of this understanding is to determine how a country's business entities measure, summarize, and finally report their economic transactions to their stakeholders. This leads us to the primary purpose of our paper, that is, to examine the origins, development, growth, and the current state of accounting in Pakistan.

Earlier research focused on the development, diversity, and classification of accounting practices of different groups of countries (Dacosta, 1978; Frank Walter, 1979; Nair and Frank, 1980; Doupnik, 1987). A recent review of accounting literature (Mueller, 1967; Meeks & Saudagran, 1990; Doupnik & Salter, 1995; Gernon & Meek, 2001) reveals that the level of economic development, nature of business enterprises and their relationships with providers of capital, political and economic ties, legal system (common vs. code law), tax laws, inflation levels, and level of education are important environmental factors that influence accounting practices.

The contribution of our study to the literature on development of accounting in a country lies in Pakistan's unique research setting. Pakistan is an Islamic Republic located in a region that has great economic potential. It has been following International Accounting Standards (now known as International Financial Reporting Standards) since 1985. Meeks and Thomas (2004), in a review of international accounting research, state that Islamic nations have been mostly left out of the accounting development research and it will be very interesting to see how insights about these countries will fit into the overall analysis conducted on other nations and countries by different academics.

International financial institutions, such as the International Monetary Fund, The Asian Development Bank, The USAID, the World Bank, and the Paris Club, all have been involved in the economic development of Pakistan in one form or another and have vested interest in knowing how their funds (loans, grants, etc.) are allocated and used and how these allocation decisions impact different facets of the Pakistan economy. Similarly, it is becoming increasingly common for international investors and creditors to diversify their risks by investing in capital markets of other countries. Pakistan offers a promising investing opportunity to these foreign investors. Pakistan's stock market in Karachi was termed by American news network, CNN as Asia's best performing market in 2002 (up more than 112 percent)¹. However, in order for creditors, investors, analysts, and other stakeholders to make rational decisions, they must overcome the challenge of understanding and interpreting the reporting framework of the concerned country. In case of Pakistan, our paper will assist them in their endeavors.

Islamic Republic of Pakistan – A Profile²

Pakistan, a nuclear power and a land of more than 140 million people is situated in

¹ <http://edition.cnn.com/2002/BUSINESS/asia/12/31/asia.stox2002/>

² Some information about Pakistan has been adapted from "A note on Pakistan" by Professor Wasif M Khan of Lahore University of Management Sciences

South Asia. Pakistan was previously a part of the British colonial Raj. In 1947, the Indian Sub-Continent was partitioned into two sovereign States of India and Pakistan. An unresolved dispute over Kashmir (a Muslim majority state of the undivided India) led to several bloody wars between Pakistan and India. Until 1971, Pakistan was comprised of two parts (West Pakistan and East Pakistan) separated by almost 1000 miles of India's territory. In 1971, following a war with India, the country's eastern wing declared itself as an independent country and named it Bangladesh.

Geographically, Pakistan (as it stands now) stretches out 1000 miles north from the Arabian Sea; its breadth varies between 150 to 400 miles. Pakistan's population has been growing at an alarming rate for the last four decades averaging close to 3 percent annually (see Exhibit I-a). As shown in Exhibit I-a, there is a 4-fold increase in the population of the country since independence (population data is for West Pakistan, now called Pakistan) and the growth rate every year since 1981 has averaged around 2.8 percent. According to the latest census conducted in 1998, urban/rural population break-up share of the rural population has declined from 71.7 percent in 1981 to 67.5 in 1998. This shift in population is exerting tremendous pressure on the urban infrastructure leading to wide spread poverty, crime and other social ills that are typical of urban slums. Pakistan's gross domestic product has grown an average of 5% over the last five decades (see Exhibit II-a & II-b). In some years, such as in 1970-71, 1992-93, 1996-1997, GDP growth rate was less than the population growth rate.

As mentioned above, the bulk of the population lives in the rural areas, which rely on an agriculture-based economy. Wheat, (a staple food), cotton, and rice are the main agricultural products. Agriculture still contributes slightly over 25 percent to GDP, employs around 44 percent of the work force, is the main source of foreign exchange earnings, and provides linkages through which it can stimulate growth in other sectors. In fact, the rate of agricultural growth dominates other components of overall economic growth. Manufacturing is the second largest sector of the economy accounting for 17 percent of the Gross Domestic Product. Major industrial products include textile & apparel, leather, cement, food and allied, paper and board and chemical, rubber and plastic. The cotton and cotton textile industry are the backbone of Pakistan's industrial economy. It continues to enjoy the status of the largest industry and commands comparative advantages in resource utilization. It accommodates the highest number of the industrial labor force (38 percent) and largest source of foreign exchange earnings (60 percent), and it accounts for 27 percent of the value addition in the manufacturing sector. Exhibit III-a shows recent (2000-2003) exports of principal commodities. The major finished-products exports include cotton-yarn, cotton-fabrics, knitwear, bed-wear, readymade garments, synthetic textiles, carpets, sports goods, leather manufactures and surgical instruments. Most recent (2000-2003) primary imports of the country reported in Exhibit III-b include petroleum products, agricultural and other chemicals, machinery and transport equipment, and food items. Exhibit IV provides an overall summary of foreign trade since 1951. The country has continuously experienced huge trade deficit year over year since 1951, quite typical of underdeveloped countries.

Historical Perspective of Accounting in Pakistan

History of accounting in the Indo-Pak subcontinent is very ancient. Gladwin (1796) suggested that, in India in 1583, there was a Hindu method of accounting before the adoption of Persian mode. In Hamilton's (1798) opinion the Hindu method of accounting used by Bengali traders was a double-entry system. Lall Nigam (1986) drawing support from Hamilton (1798) contended that the system used by Indian traders was a predecessor to the Italian method and was transported to Italy by Indian exporters. Though Nigam could not present any physically existing evidence in support of his claim (see Nobes, 1987),

Indians, even back in 1191, were using a bilateral form of accounting, which may not be a double-entry system (Michael and Nandy, 1992).

The Corporate Laws

Accounting in Pakistan, as we understand it today, came in the Indian subcontinent (accompanied by the concept of limited liability and statutory audit), in the middle of the 19th century during the British rule, when the first *Companies Act of 1850 and 1857* were enacted. The Acts required that the companies should submit their accounts including half-yearly audits and *auditors' reports*. *These Acts were followed by the Companies Act 1883*. Companies Act 1883 gave detailed audit guidelines in term of appointment, remuneration and duties of auditors (Saeed, 1993).

Companies Act 1913

The Companies Act 1913 was next in a series of corporate laws enacted in the sub-continent. Companies Act 1913 made it mandatory for every company to maintain books of accounts with respect to: 1) Sales and purchases, 2) Receipts and payments of money, and 3) Assets and liabilities of a company. Under the requirements of this law, no person should act as an auditor of the company unless he/she held an auditor's certificate granted by the provincial governments. Central government, however, held the right to issue this certificate to members of certain professional bodies and hence to the members of British professional accounting bodies namely, Institute of Chartered Accountants in England and Wales (ICAEW), Institute of Chartered Accountants of Scotland (ICAS), and Institute of Chartered Accountants of Ireland (ICAI), who were, immediately recognized as qualified auditors. For some years, there were no examinations required for getting the practitioner's certificate, however, in 1918, the Government of Bombay instituted a *Government Diploma in Accounting* and constituted detailed rules regarding the examination and training of those who wanted to obtain the diploma and the license to audit. All provinces in British India soon adopted these rules. However, it was not until 1932 that the Government of British India framed Auditors certificates rules, 1932 to control and to regulate the auditing profession. Pakistan, after gaining independence in 1947 adopted as is the Companies Act 1913 and the Auditors Certificate Rules 1932 (Saeed, 1993).

In 1952, as a first step toward the institutional development of the profession, the practicing accountants, back then called Registered Accountants, formed a private body known as the Pakistan Institute of Accountants (PIA) to look after their own interests and to take up the accounting professional matters with the government. Soon after, there was a major post-independence development in the accounting profession - the formation of the Institute of Chartered Accountants of Pakistan (ICAP) in 1961. This was the result of both persistent pressure from the Pakistan Institute of Accountants and a realization by the government that the profession has now grown in stature and in importance to a level that warrants autonomous status. Another major development that followed quickly was the establishment of the Institute of Cost and Management Accountants of Pakistan (ICMAP) in 1966 (as a follow up to the formation of Pakistan Institute of Industrial Accountants) to regulate the profession of cost and management accountants (Saeed, 1993).

From Independence up till 1971

The financial reporting requirements of Companies Act 1913 remained in force after the nation gained independence in 1947 up till 1970. The disclosure requirements of the Third Schedule to the Companies Act were pretty rudimentary and incomplete in nature.

For profit and loss accounts, the requirements included disclosure of the following:

1. The amount of gross income (distinguishing several sources from which it has been derived),
2. The amount of gross expenditure (distinguishing the expenses of establishment, salaries, and other like matters),
3. The portion of deferred expenditure that is to be written off,
4. The amount written off for depreciation, and
5. The amount paid to directors and managing agents of the company as remuneration for their services.

For Balance Sheet, disclosure requirements included:

1. A summary of property and assets of the company disclosing their general nature and how the value of fixed assets has been arrived at,
2. A summary of capital and liabilities of the company disclosing their general nature, and
3. Disclosure in the above two categories should conform to the contents of Form F (specimen balance sheet) as given in the Third Schedule of the Companies Act.

Qureshi (1975), while evaluating the financial reporting practices in Pakistan during that period, describes the weaknesses in the specimen balance sheet given in the Third Schedule of the Companies Act:

“...It does not suggest a classification of assets according to their nature, such as current assets, fixed assets, intangibles, long term investments and so forth; intangibles like good will, trade marks, patents, etc. are described as fixed assets; and preliminary expenses and underwriters commission lack proper classification. There is no suggestion to classify the capital and liabilities side of the balance sheet into current liabilities, long-term liabilities, and shareholder’s equity. Profit or deficit is not shown as part of or deduction from stockholders equity, instead, the deficit appears separately on the asset side of the balance sheet. Similarly, the un-appropriated balance of profit is listed as an item of liability and not as part of equity. The provision for bad and doubtful debts is shown as a reserve and not as deduction from receivables.”

Qureshi (1975) identifies other weaknesses in financial reporting practices of the firms that included absence of disclosure of accounting policies, failure to maintain distinction between reserves and provisions, and the valuation of assets in the balance sheet at gross value.

“...various sources of revenue were distinguished, but the gross revenue was not broken down by product line, major business activities or by different segments in case of a conglomerate. Valuation of year end inventory was described such as lower of cost or market value but the method applied for relating different cost of products acquired to periodic revenues such as LIFO, FIFO, AVERAGE was not disclosed. Similarly in twenty out of thirty reports that were examined, auditors had relied on certificate given by the management regarding the valuation of year end inventories and no audit report had mentioned the fact that inventories were not covered by their opinion.”

Post 1971 to 1984

In 1970, the Securities and Exchange Authority, a semi autonomous body created by the government, developed certain rules to improve financial reporting practices in the country. These rules were published in 1971 and became effective in 1972. These rules required substantially increased disclosures. For the first time, the publication of semi-annual accounts for listed companies was made mandatory. Equally important was the

requirement to disclose transactions between the associated companies describing the aggregate sales, purchases, and balance transfers between associated companies.

Soon after the formation of The International Accounting Standard Committee (IASC), Pakistan became its member in 1974. Since Pakistan never had any national accounting standard of its own, Institute of Chartered Accountants of Pakistan (ICAP) encouraged its members to recommend to their corporate clients to prepare their financial statements in conformity with the International Accounting Standards (IAS). It was not mandated that incorporated businesses should prepare their financial statements on the basis of IAS. Later, the Companies Ordinance 1984, Section 234 made it mandatory for listed companies to comply with all those IAS that have been notified by Corporate Law Authority on the recommendation of ICAP. The unlisted companies were and are still not required to comply with requirements of IAS (now known as International Financial Reporting Standards, IFRS). Annexed to Companies Ordinance 1984 were the Fourth and Fifth Schedule, providing disclosure requirements for listed and unlisted companies, respectively. Listed companies were hence required to comply with requirements of the Fourth Schedule as well as IFRS.

Companies Ordinance 1984

Companies Ordinance 1984 included some critical requirements, given the corporate context of the country. The three critical requirements were: 1) The remuneration disclosures of directors', chief executives, and those of auditors (where auditors' compensation segregated between audit fees and other services), 2) That every company passes a special resolution (under Section 208 requirement) before it transfers funds of the company to any other associated company in the form of loans or advances, etc. This section also required companies to ensure that total amount of advances/commissions to associated company should not exceed 20% of the paid up capital plus free reserves of the lender company. In order to monitor activities of organizations in this regard, a clause was inserted in the Fourth Schedule of the Companies Ordinance 1984 that required companies to disclose maximum balance due to and due from associated companies at the end of any month during the year, and 3) It was made mandatory for directors of companies to disclose in their reports accompanying the accounts, the following:

- (a) Disclosure of any material changes and commitments affecting the financial position of the company which have occurred between the end of the financial year of the company to which the balance-sheet relates and the date of the report;
- (b) So far as is material for the appreciation of the state of the company's affairs by its members, directors report should deal with any changes that have occurred during the financial year concerning the nature of the business of the company or of its subsidiaries, or in the classes of business in which the company has interest, whether as a member of another company or otherwise, unless Corporate Law Authority (now known as Securities and Exchange Commission of Pakistan) exempts any company from making such disclosures on the ground that such disclosures would be prejudicial to the business of the company;
- (c) Directors' report to contain the fullest information and explanation in regard to any reservation, observation, qualification or adverse remarks contained in the auditor's report;
- (d) Circulate with it information about the pattern of holding of the shares in the form prescribed;
- (e) State the name and country of incorporation of its holding company, if any, where such holding company is established outside Pakistan;
- (f) State the earning per share;

- (g) Give reasons for incurring loss and a reasonable indication of future prospects of profit, if any.

In addition, through an amendment made in 1999 in the Companies Ordinance, directors were also required to disclose information about defaults in payment of debts, if any and reasons, thereof.

1984 to Present - Developments

Financial statements of listed companies continued to improve into 1990s with a number of new international accounting standards issued by the IASC (now known as the International Accounting Standards Board IASB). These standards were issued as part of core standards project specified by International Organization of Securities Commissions (IOSCO) to IASC before it would consider endorsing IAS for cross-border listing of companies on the international stock exchanges of the world. Most of these standards were adopted by SECP (Securities and Exchange Commission of Pakistan) on the recommendation of ICAP along with many old standards that were not adopted earlier.

Issuance of the Code of Corporate Governance

Another major development in the financial reporting system is the code of corporate governance issued on March 28, 2002. Some of the salient features of the code with specific reference to financial reporting and auditing issues include:

1. Contents of Directors Report to members in addition to requirements of Section 236 of Companies Ordinance 1984 to include:
 - A statement with regard to the compliance with IFRS as applicable in Pakistan for the preparation of financial statements and disclosures of any departures from the same;
 - Information regarding the system of internal control being adequately designed, implemented and monitored;
 - Directors view regarding the going concern ability of the entity;
 - A statement to the effect that there have been no material departure from best practices of corporate governance, as detailed in listing regulations;
 - Key summarized operating and financing activities data of last six years;
 - Declaration of reason in case the dividends have not been declared;
 - Pattern of shareholders - disclosing the name-wise details of i) institutional shareholders, ii) holdings of directors and their spouses, iii) details of associated companies, and iv) shareholders holding more than ten percent of the total holdings.
2. The most important provision of the Code with reference to financial reporting is the requirement for listed companies to publish quarterly un-audited financial statements. These have to be accompanied by a director's review on the affairs of the company during the quarter. This is the first time that listed companies in the country are required to report quarterly results. Prior to this, listed companies were required to publish half-yearly accounts that could be un-audited as well.
3. Another important provision relating to financial reporting of listed companies is that all listed companies are now required to ensure that annual audited accounts are circulated not later than four months from the end of financial year of the company. The earlier requirement as per the Companies Ordinance 1984 for both listed and non-listed companies was six months.
4. Companies are required to include in the annual report a statement of compliance with the Code of Corporate Governance. The auditors of the company are required to review and give an opinion about the compliance. Given the nature of work,

auditors give a moderate assurance on statement of compliance with the Code of Corporate Governance.

In summary, we provided a brief account of evolution of institutional structure of accounting and financial reporting in the country. In the next sections we shall explore the effects of different environmental factors that shaped the accounting system of the country.

Economy, Politics and the Legal system

Pakistan has had a turbulent political and economic history. Since gaining independence, she had to accede to forces of secession and independence and in that process lost one-half of the country (previously East Pakistan, now Bangladesh). The country has had successive military governments, which assumed powers after the dismissal or overthrow of civilian governments. In the last twenty-five years, six elected governments have been dismissed or overthrown. The uncertainty generated by this continuous upheaval in the political and economic environment has significantly and negatively affected the economy, the corporate governance structure, and the nature of business and the industry.

The 1960s were noted for the government's attempt to foster import substitution industries through direct control by sanctioning industrial projects. Several industrial families emerged in a wave of capital intensive and mostly low-value added businesses, mainly in textiles. Most of the industrial growth achieved by these family-owned enterprises was greatly supported by the government in the form of industrial licensing procedures, overvalued exchange rates, tariff protection against imports, input subsidies, and preferential access to capital (White, 1974). Foreign assistance played a major role in the development of the economy (see Exhibit V). As shown in Exhibit V, the amount of foreign loans and grants doubled during the 1960s increasing from 842 million dollars in the 1950s to around 2.4 billion dollars in the decade of the 60s. The country during this time saw high industrial growth and this era thence is known as the decade of development (1958-68). For example, the GNP, which stood at Rupees 31.439 million in 1964 rose to Rupees 48.280 million in 1967-68; a rate of growth of 6% during the years 1965-68³. During this period, there was tremendous increase in the industrial output in all the sectors especially in textile, jute and sugar. Number of joint stock companies increased significantly from 3,853 in 1957-58 to 8,654 in 1967-68⁴. Pakistan's efforts to survive and develop were so successful that it was described as the most remarkable example of state and nation building in the post-World War II era⁵. But according to some critics, there was a downside to this economic development.

“Pakistan attained economic development but at the cost of social justice. GNP grew rapidly, but so did skew-ness in the distribution of income and wealth, rendering the rich richer and the poor poorer. Industrial expansion was remarkable but economic power became concentrated in the hands of a small elite class. Gross domestic savings as a proportion of GNP rose markedly, but it consisted mostly of undistributed corporate profits plus depreciation allowances, and came about in response to such fiscal incentives as the tax holidays.

³ Investment in Pakistan-Background and perspective (Karachi: the department of Investment promotion and supplies, (Government of Pakistan, 1968), p23

⁴ 25 years of Pakistan in Statistics 1947-72-Central statistical office, Economic affairs division, Ministry of finance, planning and development, government of Pakistan, 1972), p155

⁵ The Times, London, February 6, 1966

Even dividends in majority of cases were payments within controlling group or group of companies, which were reinvested”⁶.

The development of stock market was made possible with the development of Karachi and Dhaka (later, the capital of Bangladesh) Stock Exchanges. The closely held corporations discouraged small investors to become owners for fear of diffusion of ownership. Trading on the stock exchange therefore represented transactions between select groups of people. During the 1970s, following the loss of the country’s Eastern half, we find a significant backlash against the perceived or real inequities created by the market friendly economic policies of the 1960s. The popularly elected government of Mr. Z.A. Bhutto, driven by political expediency, led a wave of nationalization, sending the industrial groups from the 1960s into virtual hibernation and even into exile. Nationalization of the commercial banks in 1974 opened a new chapter in political patronage - industrial loans were sanctioned to political or ethnic cronies, often in wanton disregard of prudent economic sense and sound decision-making (Shahid-ur-Rehman, 1998). For project financing of large industrial projects, the government launched development finance institutions such as the National Development Finance Corporation (NDFC). After the civilian government was overthrown in a military coup in 1977, the previously nationalized financial institutions continued to be run by the government. In a White Paper issued by the military government in 1979 on misuse of banks by political government, it was stated,

“...the aggregate amount of advances of half million rupees and above which were classified as doubtful or irregular in the State Bank Inspection Report of December 31, 1975 is over Rs 1,340 million. Advances of half million rupees or above given by the banks after nationalization which have been found to be bad, doubtful or irregular abinitio amounted to Rs 510 million”. It also found that nationalized commercial banks sanctioned loans worth Rs 562 million under irresistible political and administrative pressure or influence between 1974-77”.

The 1980s were marked by the lingering Afghan civil war, which resulted in a displacement of almost 4 to 5 million Afghans seeking refuge in Pakistan. This in turn caused a unique set of serious problems that included proliferation of weaponry and widespread trade and use of illicit drugs. At the same time, Pakistan reaped economic dividends in the form of a substantial increase in foreign assistance. This assistance was in the shape of grants as well as foreign loans. Some of this aid was utilized to revive the private sector resulting in renewed concentration of wealth in a few hands and primarily in one business sector (i.e., textile sector). Though Pakistan has been receiving foreign loans from international donor agencies since the 1950s, it was during the 1980s that the accumulated external debt rose to approximately fifteen billion US dollars.

The 1990s were most notable for the country’s multiple experiments in democracy, which had started on tender footings back in 1988. By 1999, three elected Prime Ministers were removed from office. During that time, the country also saw rapid expansion in the capital markets resulting in increased number of listed companies on the three major stock exchanges of the country (see Exhibit VI). As shown in Exhibit VI, the number of listed companies increased from a total of 314 to 487. Some important developments of the 1990s were the huge loan-defaults by politically connected and influential industrialists, the continued public financial assistance of the public and private sector resource-sucking sick industries, and the occurrence of massive corporate failures. According to Shahid-ur-Rehman (1998),

⁶ Role of private sector in Pakistan’s development, pp-52-53

“Three lists of bad loans have been published since 1993, the first published by caretaker Prime Minister Moeen Qureshi, followed by two lists released by Benazir Bhutto and caretaker govt [government] of Meraj Khalid, in October 1996, and in January 1997, respectively. The bad loans which were Rs 1,340 million when Z A Bhutto was removed swelled to Rs 80 billion in August 1993, Rs 126 billion in November 1996 and Rs 130 billion in January 1997.”⁵

Some of the high profile corporate failures included Mehran Bank, Mohib Textiles and Taj Company. These horrendous corporate failures seriously undermined the faith of the public both in the capital markets and in the monitoring mechanisms of the government.

Formation of Securities & Exchange Commission of Pakistan (SECP)

Pakistan’s accelerating external debt and her diminished ability to repay the interest and the principal resulted in increased involvement of international donor agencies (such as the Asian Development Agencies and the International Monetary Fund), in the fiscal and monetary policy making of the country.

In this regard and as part of the capital market regulation reforms of the Asian Development Bank (ADB), Securities and Exchange Commission of Pakistan (SECP) was formed in 1999, under the Securities and Exchange Act, 1997, to monitor the activities of corporate and capital markets and all related players. The responsibilities of SECP under the Securities and Exchange Act, 1997 included:

1. Regulating the issue of securities;
2. Regulating the business of stock exchanges and other security markets;
3. Supervising depository and clearing houses;
4. Registering stock brokers and sub-brokers;
5. Regulating investment schemes and funds;
6. Preventing frauds in securities markets; and
7. Regulating share acquisition and mergers/takeovers of companies.

The Securities and Exchange Commission of Pakistan (SECP) succeeded the Corporate Law authority (CLA), which had been administering Corporate Laws in the country since 1981. The CLA was a government department attached with the Ministry of Finance and therefore, lacked the autonomy to build a regulatory structure that was conducive to the growth of the financial sector. Due to CLA’s typical bureaucratic structure, it was difficult for it to effectively pursue transparency, disclosure and authenticity, and establish an upright financial sector. The rapid expansion of the stock markets (opening of a stock exchange in Islamabad, capital of Pakistan) during the early 1990s further highlighted the need for the establishment of an independent regulatory body with full operational and administrative autonomy⁷.

The Emergence of a Nuclear State and the Aftermath

Pakistan’s tests of nuclear devices in 1998 resulted in the imposition of various international sanctions. Foreign economic assistance (as shown in Exhibit V – dropped from 10.2 billion US dollars during 1993-1997 to 7.4 billion US dollars during 1997-2001) and the foreign direct investments (already limited) dried up. Consequently, the country’s economic indicators worsened.

⁷ Chairman of SECP in the Chairman’s Statement accompanying the annual accounts for the Commission for the year ended June 30, 2000

The government made significant attempts, during this period, to focus on stabilizing rather than growing the economy. This, in turn, led to collapse in investments and increase in poverty and in unemployment. The heavy expense of debt servicing and defense had a further depressing affect on dimly performing social indicators such as the literacy rate (down to 38%), high population growth rate (averaging around 2.1%) and ever-worsening public health.

Code of Corporate Governance

As mentioned in the earlier section of this paper, the Securities and Exchange Commission of Pakistan took an important step forward and introduced a set of proposals in the form of a Code of Corporate Governance (CCG), whereby listed companies would be managed in compliance with international best practices. This Code was prepared based on the initiatives taken by the ICAP in 1998.

Pakistan faces the same corporate governance challenges that are typical of emerging economies. These challenges manifest themselves in the form of loan-defaults, large-scale tax evasions, non-payment of dividends to shareholders over longer periods of time, and continued government's financial and managerial assistance of large number of sick industrial units. The purpose of the CCG was not only to address such problems, but also to boost investor's confidence in the functioning of corporate entities, and to induce mobilization of savings through equity and debt markets. The final draft of the Code was issued by SECP on March 28, 2002. The Code was enforced on listed companies through its inclusion in the listing regulations of all three stock exchanges of the country.

Mueller (1968) suggests that the stage of economic development, type of the economy, and the growth pattern of the economy, can impact a country's accounting practices. Douppnik & Salter (1995) argue that the stage of development affects the type of business transactions that are conducted in a country and the nature of economy determines which transactions are more prevalent. On similar conceptual lines, we can relate evolution of Pakistan's accounting practices to three economic development periods – private sector driven economic development, nationalization, and de-regulation/privatization, discussed next.

Private Sector Development

It is interesting to note that during 1960s decade (widely recognized as the decade of development for Pakistan), we do not notice any change in the financial reporting requirements for the incorporated businesses. Fairly primitive reporting requirements of the Companies Act 1913 continued to remain in force throughout this period, even though, as mentioned earlier, the number of incorporated businesses tripled in this decade (i.e., from 3,000 to 9,000). The emergence of family-based business groups on the corporate scene (a recurring institutional story in the non-USA business setting) and the heightened concern of the populace regarding wealth concentration in the hands of a few selective families became dominant political issues of this period. These worries were augmented by concerns of malpractices, (real or perceived), in which these business groups were purportedly involved. Examples included, evasion of taxes, lack of distribution of dividends and transfer of funds/profits from one company to another within the group (in the form of advances and loans), and inter-company sales and purchases of goods and services.

It was not until 1972 that a significant increase in disclosures by incorporated businesses were instituted through the promulgation of the Securities and Exchange Authority Rules of 1971. The new rules regarding disclosure of transactions between associated companies certainly seem to be in response to the risk of such perceived malpractices identified earlier.

Listing regulations of Karachi stock exchange added a provision (under the new rules) stating that if a company does not declare dividends for five consecutive years, its shares would be black listed and suspended from trading. This provision was in response to minority shareholders' persistent complaint dating back to 1960s that management of highly profitable family businesses was hesitant to distribute dividends for long periods. For the next two decades, little if any changed in practice for the minority shareholders. Eventually, through the fiscal budget 1998, an amendment was made to the Income Tax Ordinance 1979, whereby, if a company's retained earnings exceed 50 percent of the paid up capital, the excess amount will be deemed to be the earnings of the company for the fiscal year and will be taxed accordingly. These changes found their way to the disclosure requirements of year 2001, when the Code of Corporate Governance made it mandatory for companies to disclose in directors' report the reasons for non-declaration of dividends in a particular year. The aforementioned example points to an event, which initially affected listing regulations, later the tax laws, and finally the accounting system. Another reporting requirement that seemed to have arisen from the issues rooted in the 1960s decade is an amendment, in the year 1999, made to Section 236 of the directors' report, whereby the directors are now required to provide reasons if the company has suffered a loss and also give a reasonable indication of the prospects of profitability.

Nationalization Era

The 1970s decade constitute the second phase of the political and economic history of the nation that experienced a major shift in the policy of the popularly elected government of Prime Minister Z.A. Bhutto. A number of large industrial units, banks, and insurance companies were nationalized both to soothe popular anger against 'twenty-two families' (see White, 1974) and to open the doors to large stash of wealth for political expediency (as alleged later by the military government that overthrew the elected government). This radical change in economic and political system of the country was expected to cause major changes in the accounting practices of the country. This expectation is based on the experience of the Peoples' Republic of China. The communist revolution of 1949 resulted in the dominance of state-owned enterprises leading to a fundamental change in the economic landscape of the country. This in turn had a lasting effect on accounting and financial reporting in China (Lynford E. Graham & Chuin Li, 1997). In the context of China, the system brought a uniform set of standard accounts and a balance sheet focus (sources and application of funds) for accounting (Lou, Wang & Enthoven, 1988). Unlike China, however, there was no change in the financial reporting framework of Pakistan despite major nationalization campaigns carried out by the government during the early and mid-1970s.

Deregulation/Privatization

The issue of huge non-performing loans granted to political cronies by successive governments since 1970 became a major issue in the late eighties and particularly, in the early nineties. By an amendment made in Section 236 of the Companies Ordinance on July 27, 1999, directors were now required to disclose in their report accompanying the annual accounts, information about loan default, if any, and the reasons. However, it still took many years before this particular disclosure item was made mandatory for incorporated businesses of the country.

Common Vs. Code Law Classification

International accounting literature, for long, has recognized the prevalence of a particular legal system (common law or code law) to be an important variable affecting the accounting system of a country (Fantl' 1971; Nobes 1983; Berry 1987). The literature recognizes

common law countries as oriented towards fair-presentation, transparency, and full disclosure (known as the Anglo-Saxon model). Standard setting is carried out in these countries by the private sector bodies and the stock market is the dominant source of financing for corporate entities. On the other hand, in code law countries, banks or governments are the main sources of financing and financial accounting is geared towards creditor protection (known as the Continental model). Financial reporting, in these countries, is more aligned with the tax laws and thus, is characterized by low level of disclosures. In addition, governments have significant influence in setting accounting standards. More recently, La Porta et al. (1997, 1998, 2000), suggest that the type of legal system in a country predisposes it towards its principal system of finance. That is, a common-law legal framework emphasizes shareholders' rights and offers a stronger investor protection system as compared to that of a code-law legal system. This linkage leads to the development of strong equity markets in common-law countries and weak ones in code-law countries. Consequently, in code-law countries, debt rather than equity becomes increasingly more important as a source of financing.

The case of Pakistan is indeed a puzzle. It is generally viewed as a common law country, mostly because of its British colonial past and its adoption of the International Accounting Standards very early on. In addition, it has separate sets of reporting requirements (tax reporting and financial reporting), minimal influence of labor (as stakeholder) on corporate governance, and no direct involvement of government in standard setting. Conversely, if we explore a little deeper we find that Pakistan exhibits more of the characteristics of a code law country. It has a weak equity market, dominance of family-owned big businesses (business-groups), strong preference and use of debt as a source of financing (as against use of outsiders' equity) and a general perception of low quality of financial reporting (Baig, 1997). Thus, we can comfortably place Pakistan next to a group of code law countries even though the contemporary models of accounting practices of different nations place her otherwise.

Enforcement Predicament

Quality of financial information is a function of both the quality of accounting standards and the regulatory enforcement or corporate application of the standards (Kothari 2000). The incentives to produce quality financial statements are low in the absence of effective enforcement mechanisms. The extent to which standards are enforced and violations prosecuted are as important as the standards themselves (LaPorta, et al.; Sunder 1997, p.167). Hope (2003a) describes enforcement mechanisms as consisting of rule of law, shareholders' protection, insider trading laws, judicial efficiency, and audit spending. Historically, enforcement mechanisms in Pakistan have been embarrassingly weak. Company Law was considered to be the most un-administered law of the land. In addition, minority shareholders' protection regulations have long been inadequate. Efforts were made in the sixties and later to improve the situation. These efforts included promulgation of Securities and Exchange Ordinance 1969, Monopolies and Restrictive Trade practices Ordinance 1970, Securities and Exchange rules 1972, and formation of Corporate Law Authority in 1981. Other measures included amendment in Chartered Accountancy Ordinance 1961, whereby the Institute of Chartered Accountants of Pakistan was given the freedom to choose the president of the Institute rather than ex officio appointment of a federal secretary as its president by the government. In 1983, the ICAP got its first independently elected president. Some serious measures, to improve the enforcement climate were adopted in late 1990s with the formation of an effective regulatory body called the Securities and Exchange Commission of Pakistan (SECP).

Enforcement - Role of the Accounting Profession

The Influence and independence of the accounting profession is an indication of the effective enforcement of accounting standards (Ball et al, 2003). Corporate environment of family-owned and -managed firms in Pakistan pose serious threats to independence of auditors. In the words of a senior partner of a top-four firm, “It is very difficult to stand against the aspirations of management, if they own more than seventy percent of voting rights.” Coffee Jr. (2001) described litigation against auditors and damage to their reputation as the most important deterrents against any potential collusion of auditors with management of the audited firm. To the best of our knowledge, there has never been a litigation case against the auditors in Pakistan. Regulatory action by ICAP against its practicing members was minimal. However, the enforcement environment has improved somewhat after the formation of SECP. According to the annual report of the SECP.

“The enforcement and monitoring division (EMD) of the SECP during the year under review identified several cases of negligence of statutory auditors where they had failed to act in conformity with the statutory requirements. The audit reports issued by such auditors failed to report material facts about the affairs of companies or otherwise contained untrue statements. Previously, the Commission used to refer such cases to Institute of Chartered Accountants of Pakistan for taking necessary disciplinary action against the concerned auditors. In view of delays noted in disposal of these cases, the Commission decided to invoke the provisions of the Companies Ordinance, 1984 to proceed against auditors for negligence and professional misconduct in conducting statutory audit of listed companies. Accordingly, the EMD initiated proceedings in 25 cases against 20 firms of chartered accountants during the financial year 2002. Penalties were imposed in 21 cases while four cases were pending as of June30, 2002.” (2002 Annual report of SECP)

ICAP has also become more active in pursuing cases against its practicing members and in taking action against those auditing firms that are found guilty. They do so by publicly reprimanding them. The cases and the actions taken by ICAP and SECP against these audit firms is publicly available information and can likely cause damage to the reputation of firms. There is a wide spread belief in the profession that these measures have definitely improved the quality of financial reporting practices in the country (Ashraf & Khalid, 2005).

Another recent development towards the role of the profession in improving the regulatory environment is the Quality Control Review Program (QCR) started by Institute of Chartered Accountants of Pakistan. Even though the Program has been in place since 1987, its true significance emerged after the implementation of the Code of Corporate Governance. This code required auditors of listed firms to get a satisfactory rating in the Quality Control Review Program stipulated by the Institute of Chartered Accountants of Pakistan. Without the satisfactory rating, auditors may not audit any listed firm. Institute of Chartered Accountants of Pakistan has been giving special importance to this program since the late 1990s. A number of chartered accountants were hired by ICAP to conduct the program under the supervision of the Quality Control Review Committee (QCR). According to the process requirements of the program, every audit firm has to submit a complete list of the audit clients as of June 30th of a particular year to ICAP. Every audit firm is required to undergo Quality Control Review at least once in two years. The Professional Standards Compliance Department (PSC) selects five (maximum) audit engagements, which will preferably be listed companies and/or high-risk audit engagements, from the list of clients provided by the audit firm under review. The clients selected for QCR are communicated to the audit firm through a letter from the PSC department. Date of review is set after

coordinating with the audit firm. One client is selected from the five clients selected earlier for QCR on the day of the review. Audit working papers and correspondence files are reviewed to determine whether or not the quality of work performed was in accordance with the International Standards on Auditing. On completion of the QCR a report is issued which in conclusion states whether the standard of work performed is in accordance with or not in accordance with International Standards on Auditing. All reports are presented to the QCR for review and approval. In case the report is not satisfactory, a revisit is performed after six months. During the year 2003, 85 practicing firms were given satisfactory ratings under the program. It is important to note here that the total number of practicing firms of accountants registered with ICAP during the same period were more than 380. ICAP is the only accounting body whose members are licensed to audit the public limited companies (S254 of Companies Ordinance 1984). As of June 30, 2003, the total number of ICAP members is 3,026 of which 270 are sole proprietors and the remaining having partnerships of two or more partners for a total of 100 firms (Ashraf & Khalid, 2005).

Audit Fees

Low spending on audit services has always been a concern for accounting profession in the country. The situation got so worse that ICAP had to issue a circular in 1999 describing minimum audit fee to be paid to auditors.

In Pakistan, in the absence of any key incentives for the main constituents of the accounting system, such as the corporate entities and auditors, it is the strengthened role of regulators that we feel has the most pronounced effect on accounting practices of the country. Ball et al. (2003) concluded from their work on four East Asian countries that nations trying to improve the quality of their financial reporting should try and change auditors and managers incentives. Pakistan's experience shows us that, in the absence of any perceived need of owner-managers of listed companies to pursue equity capital, the only way to change these incentives is to strengthen the role of regulators. Our conclusion has policy implications for all developing economies that are actively seeking improvement in the quality of their financial reporting.

Effects of taxation laws on Accounting

It is generally believed that, in the absence of any particular need for outside capital, the dominant motivation for firms managed and controlled by families (business groups) to list on the stock exchanges of Pakistan, is to minimize taxes. It is interesting to note that more than half of the listed firms on the Karachi Stock Exchange are family-owned and operated. Companies listed on the stock exchanges are required to pay substantially low rates of tax as compared to companies that are not listed (see more on this in 1st schedule of the Income tax Ordinance, 2001). In exchange for the incidence of reduced tax laws, companies have to accept more stringent disclosure requirements contained in Fourth Schedule of Companies Ordinance as well as all those International Accounting Standards that have been adopted by Pakistan. Tax evasion by the family-owned and -managed companies has been a widespread concern since the 1960s. As quoted in a newspaper, M. Ali Kemal, a staff economist of the Pakistan Institute of Development Economics, reveals that according to his research, the black economy and tax evasion have risen to 10.6 percent and 11.4 percent of the Gross Domestic Product (GDP), respectively in the past seven years⁸. In commenting on the types of taxation (e.g. income tax on profits, excise duty on production, sales tax on sales, etc.) and the rates of taxation that Pakistani businesses are subjected to, Ashraf (1979) notes,

⁸ http://www.dailytimes.com.pk/default.asp?page=story_2-22003_pg7_32

“It is obvious that exaggerating costs, manipulating production records and under-invoicing sales are far more profitable techniques than any cost control technique or cost analysis.”

To a larger extent this has been a problem with a number of under-developed countries. According to Nashui (1984), it is widely believed that Turkish companies prepare three sets of financial statements, one set for external reporting, the second set for tax authorities that shows a very depressed income (to avoid a large tax liability), and the third set for banks and other lending organizations that provides a very rosy picture of the financial position of the company (to persuade lenders to extend the required credit). It is widely believed in the business circles that the notion of triple financial statements is practiced in Pakistan, as well. Some companies understate revenues and overstate purchases and other expenses to depress their profit figure. In order to tackle the problem, government of Pakistan made an amendment in 1990, whereby business organizations are now required to pay a minimum tax of 0.5% of total turnover irrespective of the level of profit or loss⁹.

In addition to understating revenues and overstating expenses, companies also manipulate other areas of financial disclosures in Pakistan. For example, companies are hesitant to disclose any “miscellaneous or other income” in their financial statements. Instead they will like to merge this figure with expenses. This is important because miscellaneous or other income is treated as a separate block of income and taxed separately according to income tax laws of the country. A recent case of tax considerations affecting corporate disclosures became apparent when mutual funds and Modaraba¹⁰ companies asked SECP to relax the application of certain provisions of IAS 39. Under these provisions, they were required to value financial instruments held for trading at market value and to treat the increase in market value of these instruments as income of the period. Modaraba companies and mutual funds are given tax exemption only in cases where they distribute 90% of their income as dividend. Treating these unrealized gains as income made it difficult for these entities to comply with the condition requiring 90% of income to be distributed as dividend. We feel that in Pakistan, tax avoidance mechanisms exercised by business entities (with tax rates as high as 60% in the 1970s and currently around 30%, not modest by any standard), have a marked impact on the accounting practices over the last five decades.

Political and Economic Ties

Different nations export and import accounting technologies like they would other intangibles such as ideologies and political systems. For instance, United Kingdom, because of its former colonial relationship, significantly influenced the accounting practices and the accounting profession of United States, India, New Zealand, Malaysia, and Pakistan. In turn, United States impacted the accounting practices of Canada and Mexico because of the geographical proximity and trade, and that of Israel because of its political affiliations. In fact, all of these countries have accounting practices and accounting professions patterned after the UK model (Gernon and Meek, 2001). As noted by Briston (1978), almost all of colonial territories in which some substantial degree of industrial development took place under British rule experienced the imposition of British Companies Act with the usual reporting and auditing requirements. As discussed in an earlier section, British, during their reign of the Indian subcontinent, implemented three Companies Acts and even after

⁹ Section 80 D of Income tax Ordinance 1979/Section 113 of Income Tax Ordinance 2001

¹⁰ It is an Islamic mode of finance where one person contributes capital and the other his skills to run a business. The profit or loss of the business is shared on agreed upon basis and in accordance with Islamic injunctions. Currently, there are Moagement compaines in Pakistan

they left in 1947, Pakistan continued the application of British Companies Act of 1913 up till 1970 (as far as financial reporting requirements are concerned). According to Hove, 1986, "Although United kingdom has had several amendments to that act, including 1948, 1967, 1976 and 1981, obviously to respond to changing requirements in the corporate environment, the act has largely remained the same in former colonies."

British Colonial Influence on Accounting Profession

United Kingdom's trained accountants have been a major source of influence on the accounting practices of the former colonized countries. In fact, Britain is the only major colonial power to transfer both its accounting ideas and accountants (Gernon & Meeks, 2001). As mentioned earlier, under the requirements of 1913 Companies Act, no person could act as an auditor of a company unless he/she held an auditor's certificate granted by the provincial governments. However, during the colonial period, Central government in the Indian-Subcontinent held the right to issue this certificate to members of certain professional bodies. Resultantly, the members of British professional accounting bodies in the Indian-Subcontinent, such as ICAEW, ICAS, and ICAI were immediately recognized as qualified auditors (Saeed, 1992). Inflow of the members of professional accounting bodies of UK continued even after partition. In fact, even today in Pakistan, members of the professional accounting bodies of UK, still enjoy maximum exemptions from ICAP examination, i.e., they can become members of ICAP just by passing the law examination of ICAP. This special privilege is accorded only to UK based institutes and to the Institutes of Chartered Accountants of Canada, Australia and New Zealand.

Role of International Financial Reporting Standards

Pakistan was amongst the first group of countries admitted for associate membership to IASC in 1974¹¹. ICAP members were encouraged to recommend to their clients to apply International Accounting Standards (IAS) while preparing their financial statements. However, a common complaint voiced by the ICAP members was that their clients often refused to observe the requirements of IAS in the absence of any legal requirements contained in the Company Law to do so. In order to force the companies to comply with the requirements of IAS, Companies Ordinance 1984 added Section 234 that specified that the listed companies should comply with the requirements of those IAS that are notified by the Corporate Law Authority (now SECP). Through a notification in 1986, 19 International Accounting Standards were adopted (see Exhibit VII). These included IAS 1, 2, 4-14, and 16-21. As shown in Exhibit VII, Pakistan, in later years, continued to adopt almost all those International Accounting Standards (or IFRS) that were issued by the IASC (or IASB). These IFRS were based on fair presentation/full disclosure model, which assumes outside shareholders as primary users of financial statements. This model originated in Britain and spread around the world wherever British influence was felt, including the United States (Gernon and Meeks, 2001). Even though this probably was not the best of models for Pakistan, as discussed earlier, Pakistan still adopted this model probably because of British influence. This practice of adoption of IAS without any modification or without any attention towards the local needs is fairly common among less developed countries (Hove, 1986). Colonial influence has certainly made its deep mark on accounting practices in Pakistan in terms of its corporate legislation, its accounting standards, and the establishment and subsequent development of its accounting profession.

¹¹ <http://www.iasb.org/about/history.asp>

Effect of International Financial Institutions

International financial institutions have been involved in the development of the Pakistan economy and its institutions since the 1950s, mainly because of close political and defence ties that Pakistan had developed with the United States and the Western world during this era. Pakistan needed this defence alliance with the West because of its hostile relationship with her neighbour India. Likewise, the western powers also considered Pakistan as a strategic and important ally during the cold war era. The foreign assistance to Pakistan increased significantly in the late 70s and early 80s when the Soviet Union invaded Afghanistan. Pakistan was given the status of a front line state in this war (see exhibit V, showing foreign economic assistance to Pakistan since 1951). Similarly, after the terrorists attack of September 11, Pakistan became a front line state in the war against terrorism and consequently reaped the benefits of significant foreign assistance in the form of grants, donations, relaxation in the repayment terms of old loans, and some write-offs of existing loans. The involvement of international donor agencies and financial institutions in the financial policy making process in Pakistan, therefore, has been there since independence (see more in Islam, 1972).

One of the major interests of the international agencies naturally has been to ensure effective management of the industrial entities in the country. Institute of Cost and Management Accountants of Pakistan was the first professional accounting body that got financial as well as technical assistance from the Government of Canada for its expansion in 1958. However, since management accountants' role in Pakistan has been geared more towards better management of industrial units, there was no substantial impact of this assistance on the financial reporting system of the country. The most important influence on the financial reporting system of the country by an international donor agency can be attributed to the Asian Development Bank, which in 1977 launched a capital market development program. The focus of the program was on mobilization and efficient allocation of long-term financing through a diversified and competitive capital market. A number of initiatives were taken in this regard that included automated trading system and settlement mechanisms, development of corporate debt market, development of new financial instruments, and most importantly, restructuring and transforming of ineffective Corporate Law Authority into Securities and Exchange Commission of Pakistan. As discussed earlier, newly enacted financial reporting regulations (through Code of Corporate Governance) and recent tightening of the enforcement regime are all a function of the newly formulated Securities and Exchange Commission of Pakistan. It is reasonable to argue that the role of international financial institutions has been critical in bringing about improvements in the quality of financial reporting in Pakistan over the last two decades.

Education Level

Radebaugh (1975) and Mueller (1968) suggested that the general level of education and/or the accounting profession of a country affect the accounting practices. According to Douppnik and Salter (1995) argue that a simple educational environment prevents development of sophisticated accounting practices. An examination of the level of education of accountants in the early years of ICAP's history shows that all members of Pakistan Institute of Accountants became ICAP's members immediately after its formation. Thus, the early members of ICAP were educated and trained from British professional accounting institutes. Later on, majority of its members were trained at local accounting firms and passed the local examination. It is reasonable to suggest that the majority of the members of the accounting profession were not very well informed about the latest developments in the international sphere. There was no research conducted in the local universities regarding emerging accounting information needs and current practices. Lack of research on the part of academics in the discipline of accounting is evident from the fact that even

today, there are hardly any books written by Pakistani authors on accounting subjects. Lack of development of any national accounting standards can also be attributed to the lack of research work and to dismal resource availability. As noted by Saudagaran & Diga (1997) in the context of South East Asian countries, lack of research resources is the primary reason that developing economies readily adopt IFRS. In addition, it is much cheaper and quicker for a nation to acquire overnight credibility among international users with respect to the quality of financial reporting by adopting IFRS (Ball et al. 2003). Pakistan started adopting International Accounting Standards without modification at a time when these standards were not very popular amongst other member countries of IASB. In some sense it seems more like “some thing is better than nothing” approach. However, adoption of these standards in a way linked Pakistani accounting profession to a source from where they could update their financial reporting system, but even more importantly, could enhance their knowledge of the latest accounting approaches and concepts on measurement and reporting of financial events.

The nature of the auditor’s report on the annual financial statements was one other evidence of the lack of awareness of accounting profession in the country. Not until 1984, Pakistani auditors always used the term “true and correct” while rendering their opinion on clean financial statements. Even the Indian Companies Act of 1956 uses the term “true and fair”, when it suggests a format for Auditors’ Opinion paragraph. This expression probably had its roots in the 1913 Companies Act, as it was commonly assumed back in those days that auditors certify the correctness (that is, “true and correct”) of financial statements. This expression was later changed from “true and correct” to “true and fair” across the international accounting circles. In Pakistan, it was not until 1984 when the Companies Ordinance required the auditors to make the change to “true and fair.”

It seems that the newly born accounting profession (wrapped in British ways), was not developed enough (in local ways) to be able to identify the specific accounting information needs of the local users and to develop accounting standards that were locally grounded. However, as the accounting profession started gaining maturity and knowledge, it became more sensitive to the information needs of the users. Consequently, in the 1990s, the ICAP became the first body to fully comprehend the significance of having a Code of Corporate Governance in the country. Toward that end, it formed a committee to work on this objective. Later on, the project was taken over by the SECP and finally a set of recommendations, which included improvements in financial reporting rules, were made through the Code of Corporate Governance in 2002. It is clear from the above discussion that the level of education or sophistication in accounting profession helps create an environment that responds to intrusions of the surroundings and brings about changes in financial reporting rules. Conversely, an unsophisticated profession will adopt a passive response to such intrusions.

Culture and Accounting Development

Recent research postulates that culture plays a role in developing and changing an accounting system (Hofstede, 1980; Gray, 1988). We argue that the major changes in the financial reporting system of companies in Pakistan came only when there were either change in the underlying legal rules and regulations and/or more importantly, there were better enforcement of these rules through active monitoring of corporate players by the regulatory authorities. Culture even if it had any role to play in the entire change process appears to be trivial. In this respect, our observation is more in line with the finding of Jaggi and Low (2000) who conclude that cultural values do not predict disclosure levels once legal origin is considered. In addition, we feel that the colonial background of a country is a key explanatory variable that should be explicitly incorporated in to any model that tests the relationship between culture and financial reporting systems. For the purpose

of our work, we conclude that the effect of culture on the accounting system in Pakistan cannot be explained unambiguously because of her colonial past.

Summary & Conclusion

The primary purpose of our paper is to study the origins, growth, and the development of accounting in Pakistan and to examine the factors that have influenced its evolution.

We traced the early days of accounting in the Indian subcontinent and described British colonial influence over the accounting of newly independent State. It is worthy to note that the Companies Act of 1913 remained in force in Pakistan beyond independence for more than three decades and it was not until 1984 that major revisions to the Act were made under the Companies Ordinance 1984. We traced the development of accounting through three eras: 1) Independence through 1971, 2) Post 1971 – 1984, and 3) 1984 to the present.

We describe how the colonial past and later the international financial institutions such as Asian Development Bank and the International Monetary Fund played a key role in shaping accounting and reporting practices of the country. Pakistan readily adopted International Financial Reporting Standards as national standards in 1985; however, the quality of financial reporting did not improve with the mere adoption of these standards. According to Ball (2003) some emerging economies adopt International Accounting Standards because it is the quickest and cheapest way to gain overnight credibility of their financial reporting system. For an emerging economy like Pakistan, we argue that it is the enforcement mechanisms (interaction between legal system, accounting system and sub-system within accounting system) that are keys to improving the quality of financial reporting.

We argue that models to describe reporting practices of different countries based on legal systems, i.e., common vs. code law (Fantl 1971; Nobes 1983; Berry 1987; Jaggi and Low 2000; Hope 2003) are not suitable in explaining the financial reporting system of a developing country such as Pakistan. Pakistan, even though is classified as a common law country in Hope (2003), exhibits most of the properties of code law countries. We conclude that lack of investor protection (minority rights protection, insider-trading protection), judicial inefficiencies, and weak enforcement mechanisms are more critical factors than are cultural factors in explaining the state of accounting in Pakistan. These legal aspects are tied to enforcement environment and do affect the “preparers’ incentives.” This has policy implication for developing countries trying to improve the quality of financial reporting of their corporate entities.

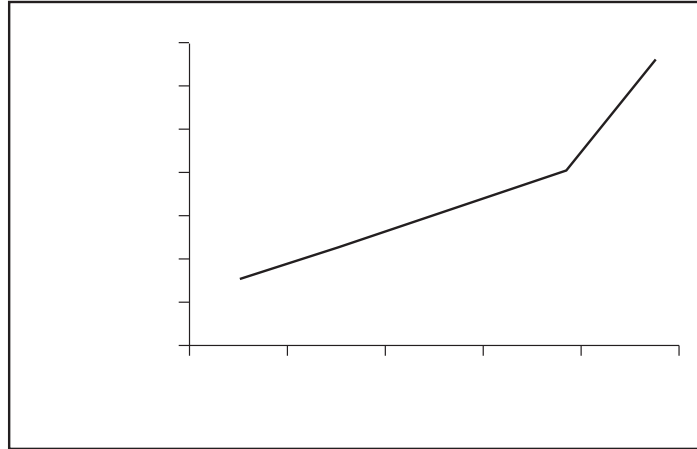
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Population & Population Growth Rate in Pakistan



Source: Federal Bureau of Statistics, Statistics Division, Government of Pakistan

Pakistan's Population Growth Rates

Year	Population (million)	Growth Rate
1981	85.09	3.06
1982	87.67	3.03
1983	90.30	2.99
1984	92.96	2.95
1985	95.67	2.90
1986	98.41	2.86
1987	101.18	2.82
1988	103.99	2.77
1989	106.84	2.73
1990	109.71	2.69
1991	112.61	2.63
1992	115.54	2.60
1993	118.50	2.56
1994	121.48	2.51
1995	124.49	2.47
1996	127.51	2.43
1997	130.56	2.38
1998	133.32	2.20
1999	136.24	2.19
2000	139.14	2.13
2001	142.01	2.06
2002	144.85	2.00
2003	147.66	1.94

Source: Federal Bureau of Statistics, Statistics Division, Government of Pakistan

Gross Domestic Product Real Growth Rates

Year	Growth rate	Year	Growth rate
1951-52	-1.80	1977-78	7.73
1952-53	1.72	1978-79	5.53
1953-54	10.22	1979-80	7.33
1954-55	2.03	1980-81	6.40
1955-56	3.53	1981-82	7.56
1956-57	2.98	1982-83	6.79
1957-58	2.54	1983-84	3.97
1958-59	5.47	1984-85	8.71
1959-60	0.88	1985-86	6.36
1960-61	4.89	1986-87	5.81
1961-62	6.01	1987-88	6.44
1962-63	7.19	1988-89	4.67
1963-64	6.48	1989-90	4.44
1964-65	9.38	1990-91	5.42
1965-66	7.56	1991-92	7.57
1966-67	3.08	1992-93	2.10
1967-68	6.79	1993-94	4.37
1968-69	6.49	1994-95	5.06
1969-70	9.79	1995-96	6.60
1970-71	1.23	1996-97	1.70
1971-72	2.32	1997-98	3.49
1972-73	6.80	1998-99	4.18
1973-74	7.45	1999-00	3.91
1974-75	3.88	2000-01	2.22
1975-76	3.25	2001-02	3.36
1976-77	2.84	2002-03	5.08

Source: Federal Bureau of Statistics, Statistics Division, Government of Pakistan

Ten Year Average Real Growth Rates (%) in GDP

			1950-51 to 1959-60	1960-61 to 1969-70	1970-71 to 1979-80	1980-81 to 1989-90	1990-91 to 1999-2000
GDP (fc)	Global Average		4.5	5.4	3.9	3.2	2.3
GDP (fc)	Pakistan		3.14	6.77	4.84	6.11	4.44
Agriculture			1.73	5.07	2.37	4.37	4.49
Industrial Sector			7.72	9.92	5.50	8.05	4.00
Services Sector			3.53	6.74	8.26	5.92	4.56
GDP	(mp)	at constant prices	--	6.69	5.59	3.41	7.75
GDP	(mp)	at current prices	3.76	10.25	17.39	13.80	14.01

Source: Federal Bureau of Statistics, Statistics Division, Government of Pakistan

Pakistan's Recent Exports - Principal Commodities

	2000-2001	2001-2002	2002-2003
	(Million Rupees)		
Total	539,070	560,947	652,294
Cotton Fabrics	60,486	69,297	78,665
Cotton Yarn and Threads	62,975	57,165	54,342
Synthetic Textiles	31,911	25,232	33,534
Rice	30,849	27,509	32,433
Sports Goods	15,919	18,623	19,579
Petroleum & Petroleum Products	10,833	11,764	14,507
Leather	13,723	14,740	13,733
Woolen Carpets & Rugs	16,877	15,122	12,690
Medical Instruments	7,293	8,896	8,767
Fish	7,994	7,746	7,867
Fruits & Vegetables (including juices)	6,072	6,492	6,696
Raw Cotton	8,072	1,502	2,873

Source: Federal Bureau of Statistics, Statistics Division, Government of Pakistan

Pakistan's Imports - Commodity / Major Groups

	2000-2001	2001-2002	2002-2003
	(Million Rupees)		
Total	627,000	634,630	714,372
Mineral Fuels, Lubricants & related materials	198,414	176,233	184,204
Machinery & Transport Equipment	121,164	135,254	171,904
Chemicals	111,259	114,930	126,404
Manufactured Goods classified chiefly by material	51,632	60,999	71,772
Crude Materials except fuel	37,162	52,079	53,964
Animal or Vegetable Oil and Fats	25,265	29,121	40,654
Food and Live Animals	52,669	32,262	29,000
Miscellaneous Manufactured Articles	15,208	17,605	21,380
Commodities & Transaction not classified	14,049	15,974	14,720
Beverages and Tobacco	178	172	368

Source: Federal Bureau of Statistics, Statistics Division, Government of Pakistan

Pakistan's Foreign Trade Foreign Trade

	Export	Imports
		(thousand rupees)
1951-52	921,925	1,473,886
1956-57	698,217	1,516,034
1961-62	542,869	2,236,256
1966-67	1,297,323	3,625,658
1971-72	3,371,393	3,495,366
1976-77	11,293,875	23,012,175
1981-82	26,269,865	59,481,537
1986-87	63,354,879	92,430,787
1991-92	171,727,714	229,889,408
1996-97	325,313,469	465,001,242
2001-02	560,947,000	634,630,000

Source: Federal Bureau of Statistics, Statistics Division, Government of Pakistan

**Foreign Economic Assistance to Pakistan
Disbursements of Foreign Economic Assistance**

Year	Loans	Grants	Total
	(Million US Dollars)		
1951-1960	192	650	842
1960-1965	1,232	1,162	2,394
1965-1970	2,324	719	3,043
1970-1978	5,096	634	5,730
1978-1983	4,418	1,375	5,793
1983-1988	5,158	2,025	7,183
1988-1993	9,540	2,541	12,081
1993-1997	9,214	1,008	10,222
1997-2001	4,555	2,918	7,473

Bureau of Statistics, Statistics Division, Government of Pakistan

**Number of Listed Companies
Karachi Stock Exchange, Pakistan**

YEAR	No. of listed companies	Listed capital (Rupees in million)	Market Capitalization (Rupees in million)
1950	15	117.3	-
1960	81	1,007.7	1,871.4
1970	291	3,864.6	5,658.1
1980	314	7,630.2	9,767.3
1990	487	28,056.0	61,750.0
2000	762	236,458.5	382,730.4

Status of Adoption of International Accounting Standards in Pakistan

Exhibit VII

Status of Adoption of International Accounting Standards in Pakistan

- IAS 1 Presentation of Financial Statements - (August 6, 1986)
- IAS 2 Inventories - (August 6, 1986)
- IAS 7 Cash Flow Statements - (August 6, 1986)
- IAS 8 Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies. - (August 6, 1986)
- IAS 10 Contingencies and Events Occurring After the Balance Sheet Date - (August 6, 1986)
- IAS 11 Construction Contracts - (August 6, 1986)
- IAS 12 Income Taxes - (August 6, 1986)
- IAS 14 Segment Reporting - (August 6, 1986)
- IAS 16 Property, Plant and Equipment - (August 6, 1986)
- IAS 17 Leases - (August 6, 1986)
- IAS 18 Revenue - (August 6, 1986)
- IAS 19 Employee Benefits - (August 6, 1986)
- IAS 20 Accounting for Government Grants and Disclosure of Government Assistance - (August 6, 1986)
- IAS 21 The Effects of Changes in Foreign Exchange Rates - (August 6, 1986)
- IAS-22 Business Combinations - (July 18, 2001)
- IAS 23 Borrowing Costs - (November 20, 1996)
- IAS 24 Related Party Disclosures - (November 20, 1996)
- IAS 25 Accounting for Investments - (November 20, 1996)
- IAS 26 Accounting and Reporting by Retirement Benefit Plans - (June 18, 1998)
- IAS 27 Consolidated Financial Statements and Accounting for Investments in Subsidiaries - (May 12, 1998)
- IAS 28 Accounting for Investments in Associates - (May 12, 1998)
- IAS 30 Disclosures in the Financial Statements of Banks and Similar Financial Institutions - (January 27, 2000)
- IAS 31 Financial Reporting of Interests in Joint Ventures - (August 15, 1997)
- IAS 32 Financial Instruments: Disclosure and Presentation - (August 15, 1997)
- IAS 33 Earnings Per Share - (May 12, 1998)
- IAS 34 Interim Financial Reporting - (January 27, 2000)
- IAS 35 Discontinuing Operations - (September 14, 2000)
- IAS 36 Impairment of Assets - (July 18, 2001)
- IAS 37 Provisions, Contingent Liabilities and Contingent Assets - (September 14, 2000)

- IAS 38 Intangible Assets - (September 14, 2000)
- IAS 39 Financial Instruments: Recognition and Measurement - (July 18, 2001)
- IAS-40 Investment Property - (January 23, 2002)

The following standards have not yet been adopted:

- IAS 15 Information Reflecting the Effects of Changing Prices – Has been classified as non-mandatory by IAS Committee and has not been adopted by Pakistan.
- IAS 29 Financial Reporting in Hyperinflationary Economies – Not relevant in the Pakistan context and has not been considered for adoption.
- IAS 41 Accounting for Agricultural property.

Most IAS's have been adopted in full, however, after some minor deviations as follows:

- 1 IAS 1 – Not mandatory for banks and insurance companies. The accounting requirements for banks are covered in the Banking Companies Ordinance 1962 and insurance companies are required to have separate classes of insurance accounts under the Insurance Ordinance 2000; only minor deviations from IASs.
- 2 IAS 16 – Allows for a revaluation of an asset to be offset against the devaluation of another asset, i.e., the offset is not restricted for the same asset, in accordance with IAS.
- 3 SECP has decided to grant relaxation to the NBFCs (that provide investment finance services, discounting services and housing finance services) from the application of IAS 39 and IAS 40 until further orders.

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Abstract

Our paper examines the origins, growth, and the development of accounting practices and disclosures in Pakistan and the factors that influenced them. We traced the early days of accounting in the Indian subcontinent and the British colonial influence over the accounting of newly independent State. We examined the development of accounting through three eras: 1) Independence through 1971, 2) Post 1971 – 1984, and 3) 1984 to the present. We described how the colonial past and later the international financial institutions such as the Asian Development Bank and the International Monetary Fund played a key role in shaping accounting and reporting practices of the country. Pakistan's adoption of International Financial Reporting Standards as national standards in 1985 did not lead to improvement in the quality of financial reporting. Pakistan, though classified as a common law country in literature exhibits most of the properties of code law countries. We argue that lack of investor protection (e.g., minority rights protection, insider-trading protection), judicial inefficiencies, and weak enforcement mechanisms are more critical factors than are cultural factors in explaining the state of accounting in Pakistan. We conclude that it is the enforcement mechanisms that are paramount in improving the quality of accounting in developing economies.

Key words: Culture, Colonial, Corporate Governance, Accounting Practices, International Standards, Pakistan.



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