Ukrainian Bank Accounting and Operations Infrastructure Development Project

For The

NATIONAL BANK OF UKRAINE

FINAL REPORT

USAID CONTRACT EPE-1-00-95-00062-00
Task Order #OUT-EPE-1-802-95-00056-00

Submitted to:
United States Agency for International Development
Boris H. von Hoffmann, Senior Banking Advisor USAID/Kiev

and

United States Agency for International Development
Jean Lange, USAIDCOTR
ENI/PER, SA-15, Rm 3236, Washington, DC 20523 USA

By

International Business and Technical Consultants, Inc.
3614 Westwood Center Drive, Suite 400
Vienna, Virginia 22182

TABLE OF CONTENTS

I. Background:

USAID has been providing technical assistance to the National Bank of Ukraine (NBU) since April 1995, to help strengthen its capacity to regulate and supervise the banking sector. The primary focus of the program has been to help the NBU's Bank Supervision Department (BSD) build up the primary components of prudential regulation; on and off-site examination, problem bank resolution, and legal underpinnings. This program, however, would have reached an impasse unless the Ukrainian banking system converted to international accounting standards (IAS). There is no way that either the National Bank of Ukraine or the general public can get an accurate picture of the financial conditions of the banks unless the IAS system is adopted. The Gosplan accounting system previously in use was designed for a time when the so-called banks served not as allocators of financial resources to the most efficient uses based upon price, but were a funnel of centrally planned financial allocations. In such a system, risk and credit analysis had no role and the accounting system reflected this. Therefore, it was critical that this conversion to IAS was made as soon as possible.

The Governor of the NBU had asked USAID to broaden its program to include particular emphasis on the implementation stage of the development of international accounting standards in the commercial banks. Bank supervision and internationally accepted accounting conventions are inter-related priorities in building a market-oriented private banking sector. Conversion to IAS was one of the most important conditions in the World Bank's Financial Sector Adjustment Loan. The implementation of IAS in the Ukrainian commercial banks is a large undertaking and AID was joined by EU/TACIS and the British Know How Fund in this program.

The National Bank of Ukraine issued, in 1997, an accounting chart for commercial banks and instructions on the new accounts based on IAS and existing requirements set up by the supervision and statistics sections of the NBU. These documents were used as guidelines by commercial banks during the implementation phase that began in October 1997. Use of the new chart of accounts and revised reporting were mandatory for all commercial banks beginning January 1, 1998.

The on-going project was divided into two components: providing technical assistance to a group of Pilot Banks (PIBs) and advising Participating Banks (PABs) in their conversion process. The final objective of the first component was to provide technical assistance to a group of PIBs so that they would have accomplished a rapid and correct transition from the existing, Soviet-based accounting system to a new accounting system which would be in substantial compliance with international accounting standards (IAS). In addition, the technical assistance should be directed to ensure that PIB management comprehends and uses correctly the IAS data produced from the new system. The second component is to assist as many Ukrainian banks as possible, the PABs, with an analysis and approval of their conversion keys from the existing system to an IAS-based system, to advise on the use of IAS valuation and recognition rules for implementation beginning January 1, 1998, and assist in the development of possible management information systems which can be prepared from the new system. The initial project was completed on September 30, 1998 and was then extended for an additional two years. In September 1999, the project was modified effective October 1, 1999, to support additional bank restructuring initiatives through December 2000.

II. Project Objectives:

This should contain a description of each one of the objectives pursued under the project and how the different tasks under the task order where structured to attain the objectives of the project.

The Task Order (TO) helps to fulfill the strategic objective of developing a more competitive and market-responsive private financial sector, and most specifically, to develop the financial infrastructure. The specific objectives are to assist the National Bank of Ukraine (NBU) in converting the commercial banks to international accounting standards (IAS) and to assist the commercial banks in upgrading their “back office” functions. The specific results expected are to achieve a transactions level conversion to IAS for banks covering at least two-thirds of the total assets of the banking system and, with a select group of banks, strengthen back office functions, such as internal audit, financial management, and fundamental systems.

The project components were restructured during the first quarter in collaboration with USAID and NBU. As of December 31, 1998, the project was divided into three components. The first component was to provide extensive in-bank technical assistance to a large bank in the system (the pilot bank-PIB). This bank was selected from the top ten banks in Ukraine and its viability is important to systemic stability.

The second component was the provision of in-bank technical assistance of lesser intensity to a group of medium-sized banks, the Partner Bank group (PAR). Collectively, the PAR group was significant to the banking system and, individually, the banks selected had the capability to provide leadership in the reform process to the rest of the banking system.

The third component was conducted jointly with the advisory team from EU/TACIS and focused on delivering a series of workshops to the Participating Bank group (PAB). This group, estimated at approximately 30 banks, was selected from the list of banks meeting NBU requirements. The workshops were directed to senior bank management and supervisory support staff and focused on the practical implementation of bank financial reporting and operational reforms using tested methodology from work in the PIB and PARs.

With the beginning of bank restructuring programs and the end of the EU/TACIS bank accounting project and related cooperative efforts, the project was again modified in September 1999, to support bank restructuring efforts and extend Kiev-based training programs on IAS and Internal Audit implementation tools into the regions. This final modification was set forth in the June 1999 Strategic Work Plan (SWP) and consisted of two major components: The Pilot Bank Program (PIB) and the Sector-wide Dissemination of IAS Implementation Tools (Dissemination Program). These components were modified and redefined beginning October 1, 1999. The project modifications included an extension through December 2000.

III. Year 1 (October 1, 1998 to September 30, 1999):

Pilot (PIB)/Partner (PAR) Bank Program:

A. Actions and Accomplishments

Year 1 Benchmarks (September 30, 1997) –

- ***IAS Conversion: By the end of the first year at least a minority of the PABs will have IAS-based financial reports at the transaction level, while the remainder will have completed subsystem design for transaction level conversion. Note: Under the revised project plan, the PABs, hereafter called the "PIB/PAR group," consist of five banks; one major PIB, Aval Bank, and four, medium-sized Partner Banks (PARs); Ukrsibbank, Energobank, Allonge, and Ukrgasprombank***.

Formation of the PIB/PAR group began immediately. In-bank arrangements were finalized with the major PIB, Aval Bank, to begin technical assistance in October 1998 and fieldwork began with the whole advisory team. Aval bank is one of the "top ten" banks in Ukraine with over Hrv. one billion in assets (approximately US$325,000,000), 90 branches, and 5000 employees.

During the quarter ended December 31, 1998, arrangements were finalized with the four PARs and on-site technical assistance was begun. The four banks selected for the PAR program were as follows:

- Ukrsibbank (Kharkiv Region)
- Energobank
- Allonge
- Ukrgasprombank

At each bank in the PIB/PAR group, a coordinating committee was formed and an inception work plan was agree upon. See Exhibit I.a for a copy of the Initial Project Workplan.

The overall focus of the initial TA was to determine the status of the IAS conversion and quality of the internal financial reporting. This was done by reviewing the existing accounting procedures at the home offices and analyzing the 9/30/98 and 12/31/98 financial statements. A preliminary IT assessment was also completed for the banks in the PAR group with the exception of Ukrsibbank which was not accessible to the IT advisor. This review concluded that a transaction level conversion had been completed by the PIB/PAB group and that the accounting procedures had generally been updated to agree with the NBU directives issued as part of the IAS conversion. We noted that none of the PIB/PAR group had programmed their in-house systems to prepare IAS-compliant internal financial statements. Accordingly, Barracuda, the software program developed by the project in 1998, was installed and used to produce the balance sheets and income statements used in our review.

A key factor in the quality of the internal financial reports was the extent to which the banks performed a complete post-closing review procedure and made the necessary correcting adjustments. As a result of our encouragement, NBU first permitted the post-closing procedures on an "experimental" basis during the last quarter of 1998 and incorporated the procedure into a final set for instructions for 1999.

Within the PIB/PAR group that there was a wide range of compliance with the NBU's instructions on post-closing analysis and adjustment procedures. Aval bank had identified several post-closing adjustments and corrected its 12/31/98 report in File 02 accordingly. During 1999, Aval also prepared formal, internal accounting procedures covering the post-closing review and adjustment process. The PARs, in general, initially had few such adjustments. We had trained the 1998 group of PIBs in this procedure using the IAS Adjustment Checklist and Barracuda, which was programmed with a post-closing adjustment feature. However, the new PIB/PARs had not received this training. Further, the accounting systems used by the PIB/PAR group were not programmed to make adjustments retroactively. Therefore, correcting entries were made in the "operating day" system (general ledger) subsequent to period-end. Although the NBU report in File 02 used these adjusted balances, they did not agree with the financial records as of the period being reported and there was no clear "audit trial" to identify the differences. This situation also effected the quality of the management reporting. Since the financial records were not corrected at period-end, management reports produced from the financial records would also not be accurate.

By the end of the first year of the project (September 30, 1999), the PIB/PAR group had been trained extensively in this process and significant progress was made in incorporating specific post-closing review and documentation procedures into their period-end closing and reporting cycle. However, the accounting systems were still not re-programmed to make adjustments retroactively limiting the ability to prepare accurate management reports efficiently from the basic accounting system.

- ***Reporting: By the end of the first year the PIB/PAR group will have a preliminary set of management reports and regulatory reports specifically tailored to their needs/requirements.***

As stated above, as of the beginning of the TA program, the PIB/PAB group had not developed software systems to efficiently prepare IAS formatted financial reports in 1998. With regards to regulatory reporting, all reporting to NBU, with the exception of the Annual Financial Report discussed below, was done in data files that are transmitted in an electronic format. Although the banks had the capability to print out hard copies of most NBU reports, the report formats were designed to serve the regulatory function and were not necessarily IAS-compliant nor were they usable for management purposes. Also, since hard copies were not required to be filed or distributed, none of the PIB/PAR group printed them out on a regular basis.

The development of the in-house capability to produce financial and management reporting tailored to the specific needs of the PIB/PAR group members, even on a preliminary basis, was not a priority of senior management and was beyond the resources that were made available within the banks for this purpose. This was especially true with the crisis environment that prevailed within the banking sector after the Russian financial crisis of August 1998 and with the continuing demands placed upon the banks to modify and expand NBU reporting. In order to overcome this obstacle, we decided to improve the Barracuda software by making it more user friendly, integrating the experimental, management reporting modules developed in 1998 into the program, and developing a new reporting package designed specifically for senior management. The new software, called Bank Management Reporting System (BMRS), was still in the development stage as of the end of the first year. However, various key components were used on a trail basis both with the PIB/PAR group and in sector-wide training during all of 1999. During this period, BMRS was the only software available for Ukrainian banks to prepare IAS-compliant balance sheets and income statements. The use of BMRS as an implementation/training tool is discussed later in this report and the BMRS User Manual and software program on CD-ROM is attached as Exhibit VIII.

At both Aval and the four PARs, the advisory team assisted the accounting staff in the preparation of quarterly financial reports using the enhanced version of BMRS. These quarterly financial statements were then reviewed by the advisor team. Not surprisingly, our review of the financial reports and analysis schedules at all five banks revealed several unusual account balances and abnormal yield and expense variations. The types of variations noted indicated the need for detailed investigation which, if conducted thoroughly, probably would have resulted in correcting entries. The financial reports together with our comments and questions were sent to senior accounting management with the request that the matters raised in our analysis be investigated in order to discuss the financial results in a follow-up meeting with senior management.

Meetings with senior management were held following our review of the quarterly results at all the five banks, including Ukrsibbank in Kharkiv, with mixed results. For example, at the meeting in Aval, senior accounting staff provided only superficial responses to our questions and, in some cases, these responses were embarrassingly wrong. However, there was a favorable outcome at Aval when, in September 1999, Aval committed to devote in-house resources to improving its financial reports. Senior management requested that we assist them in designing a senior management reporting package along the lines of our demonstration model which could be prepared directly from the banks internal software. They also committed to include these reports at the beginning of their quarterly report to the board.

As another example, the accounting management at Ukrgasprombank prepared a detailed memorandum providing all the information requested in our letter of comments on their quarterly reports. Accordingly the follow-up meetings with senior management was very informative for both parties. Further, management was quite surprised and impressed that the financial information reported through BMRS revealed so many discrepancies in their internal reporting.

Despite the commitments made by the PIB/PAR group in the project workplans to improve their internal financial reporting, it remained an “uphill” struggle to convince senior management that they needed to devote resources necessary to achieve this goal. Accordingly, many of the weakness noted in our initial assessment of the internal reporting and in our quarterly report reviews and discussions still existed as of the end of the project's first year. Some progress was noted at Aval where, as indicated above, re-programming of the internal software was begun on the development of improved internal reporting. In two of the PARs, Ukrgasprombank and Ukrsibbank, BMRS was being used to prepare reports in the accounting and analytical departments but the reports were not being disseminated on a regular basis to senior management. Again there was no evidence that senior management was requesting the reports or was using them to evaluate bank performance.

In December 1998, the NBU issued a directive requiring the preparation of an IAS-compliant Annual Financial Statement for 1998 (NBU instruction #520). This report was outside of the normal regulatory reporting and was to be submitted in hard copy, not electronically, directly to the Commercial Bank Accounting Section at the NBU. The directive contained detailed instructions on the report contents, including footnotes. Most of the financial information requested would be required in an IAS-compliant annual report to shareholders. As such, the directive represented a significant step in the implementation of transparent financial reporting in the banking sector. Unfortunately, the process NBU required to prepare these reports was more oriented to a "regulatory" reporting process than the preparation of an annual report that addressed the information needs of shareholders and capital markets participants. The banks were furnished with a template, "NewStat", which was designed to standardize the reports. NewStat, however, encouraged a "mechanical" preparation of the report. As a result, none of the reports we reviewed from the PIB/PAR group were suitable for external dissemination. The reports did not focus on material information. Instead, excess immaterial information was reported including zero balances for statement line items and references to numbers from the chart of accounts rather than descriptive titles. All of this obscured the meaningful information and detracted from the usefulness of the report to a "knowledgeable" financial statement user.

We had expected this would be the result on the first attempt at requiring full IAS-compliant reporting because the NBU instructions contained detailed account mapping but no guidelines as to what constitutes "qualitative" financial reporting. Therefore, the annual reporting process was treated as just another regulatory reporting burden. There was no evidence that senior management was involved or understood the Annual Financial Report and there was no requirement that the information be published. Therefore, the bank reporting process during 1999 remained inconsistent. For example, in Aval three separate sets of numbers were communicated as of December 31, 1998. The shareholders received the annual report in the same, non-IAS format as 1997 using balances as of the "first close", the NBU received the annual report in the format it requested but based on "post-closing" adjustments made in January 1999, and the foreign correspondent banks and EBRD received the third set of numbers in the "Big-5" audit report issued in late May 1999.

All banks in the PIB/PAB group had lists of management reports that were regularly prepared by the Financial Analysis Department and disseminated to senior management and various functional areas within the bank. In most cases, however, the interim management reports followed the pre-IAS conversion format so did not convey the information necessary to evaluate performance and manage the banks operations. Also, the management reports were typically prepared in the "Analytical Department". This department was separate from the accounting department and, in some incidences, we noted that the data reported in the management reports did not appear to agree with the basic financial records. No attempt was made to reconcile the information in the management reports to the financial records.

The plan at each bank called for development of at least two management reports that would be consistent with western management reporting and reconcilable to the financial records. During the year, we reviewed copies of key reports on the list and communicated our evaluation of the reports to senior accounting management along with our recommended changes and new reports that we believe should be added. By the end of the year, management was still considering our recommendations but no substantive changes were made to the management reports.

- ***Auditing: By the end of the first year, the PIB/PAR group will have preliminary plans for both the conduct of the report verification function and the operational audit.***

In March 1998 the NBU issued directive # 114 which required that all commercial banks implement an internal audit function. The directive described where the department should be organized within the bank and its objectives, functions and responsibilities. Directive #114 was followed in July 1999 by directive #358, which were instructions for the implementation of the standards of internal audit. The instructions in directive #358 set-forth six internal auditing standards including internal audit management, independence, scope of work, etc. The six standards contained, in condensed form, the major provisions from the internationally recognized standards set-forth in the Statement on Internal Audit Standards (SIAS). Accordingly, NBU established a solid theoretical basis to begin the process of implementing an effective internal audit function in the banks.

Within the PIB/PAB group, only Aval had a functioning internal audit department. Two of the PARs, Ukrgasprom and Allonge were too small to sustain a full-time, independent internal auditor. EnergoBank and Ukrsibbank designated an internal auditor to comply with the NBU instructions but the designation was "in name only" as the individual did not perform an internal audit function. By the end of first year of the project, no one was designated to actually staff the departments at either Energobank or Ukrsibbank. In our early discussions with Mrs. Politiva, Head of NBU's Internal Audit Supervision Department, we suggested that the instructions could provide for "out-sourcing" of the internal audit function since many of the banks in Ukraine were not large enough to justify a full-time, in-house internal audit function. Although Mrs. Politiva was receptive to our suggestion, the instructions were never amended to allow this.

The internal audit (IA) assistance began with the arrival of the IA specialist, in January 1999. Her priority during the year was to focus on the internal audit organization at Aval Bank, evaluate its effectiveness, and determine its compliance with NBU's IA directive and SIAS. The evaluation of the IA organization and operations included a two-day, on-site observation of the audit of Aval's Fastiv branch. The memo to senior management covering the evaluation of the IA organization is attached as Exhibit II.

In addition to the assessment of the IA organization and procedures, the advisory work in this area focused on the development and delivery of IA training at both the senior management level and for supervisory management within the IA department. A specific description of the IA training at Aval is covered below under the summary of the first-year training programs for the project.

In order to reinforce the theoretical training conducted at Aval, we developed a follow-on program with the IA department to perform a "pilot" audit. The pilot audit was to be supervised by the internal audit advisor and would constitute intensive, on-the-job training in the practical application of the internal auditing procedures acceptable under SIAS. To be effective, we encouraged Aval to assign a team of auditors the pilot audit in order to maximize the training benefit and develop supervisory skills. We also recommended that an audit area important to Aval be selected. The director of IA at Aval decided that the home office audit area that Aval was most concerned about was the "plastic" card operations (debit and credit). These operations were growing rapidly and, since they were new at Aval, few management personnel in either accounting or back office understand the systems and scope of operations.

Conduct of the test audit was hampered by administrative issues for most of the remaining year. First, the staff auditor assigned to the work was often re-assigned other temporary duties (this was a problem that occurred frequently within the IA department). Secondly, the recommendation that Aval assign an audit team to the program was not followed during the early phases of the work. These two factors, together with the complexity of the area being audited, continued to hamper progress. Accordingly, by the end of the first year of the project, the pilot audit had been started but with only one auditor partially assigned, had not been completed as scheduled. At the same time, progress was made in the adoption of specific SIAS procedures used in the Merchant Activity section of plastic card operations. Two major changes to Aval's audit procedures were introduced in the program for this work: sample selection and outside verification procedures using confirmation letters.

- ***Accounting Organization: By the end of the first year a majority of the PIB/PAR group will have made some documentable effort to reorganize and centralize their accounting departments***

On December 31, 1998, the NBU issued its directive, "Accounting and Reporting Policy of Ukrainian Banks". This directive set forth the basic requirements and guidelines for the accounting and financial reporting function and, therefore, any reorganization of the accounting function and development of revised policies and procedures in the commercial banks were required to be consistent with this directive.

At Aval, Bank, we initially began the analysis of accounting organization, policies and procedures by examining the various account balances and completing the IAS Adjustment Checklist procedures (work was based on 9/30/98 balances). The objective of this work was to identify those areas where existing policies and procedures were not in accordance with IAS and/or where significant improvements in internal control and efficiencies in the accounting operations could realistically be achieved. Because of the need to, first, understand the NBU

directive and, second, to organize the process by which change could be implemented internally, we anticipated that our assistance in this area would extend throughout 1999.
Aval Bank's reorganized its operations and management structure, including the accounting functions, on a preliminary basis in January 1999. We organized our assistance so that each key accounting function within the new organizational structure was assigned an Aval representative(s) from senior and supervisory management levels. The Aval representative was then "teamed" with a project foreign expert and local consultant. Work groups were then formed to begin preparation of the revised policies and procedures. The Workgroup Assignments schedule is attached as Exhibit III.a.

There were eighteen separate departments at the home office that we identified as likely needing to make modifications in the accounting policies and procedures. Each of these departments were asked to give us a copy of the departmental "charter"/(accounting policy), a list of the existing "Technological Cards" (TCs) which describe procedures, a list of those TCs that need to be modified or replaced, and the individual assigned to draft the modification. By the end of the first year of the project, the status of the information requested was as follows:

Information Requested	**Departments responding**	**Departments not responding**
Departmental charters	12	6
List of current TCs	15	3
List of TCs requiring modification	5	13
List of personnel assigned to make modifications	4	14

The process of analyzing accounting policies and procedures to insure compliance with IAS and NBU instructions, strengthen internal control, and improve operating efficiencies was a new process for most of the departments involved in the effort. Also, with the banking "crisis" in Ukraine that resulted after the August 1998 Russian collapse, the modification of accounting policies and procedures was not given the highest priority. Therefore the activity was still in process by the end of the project year.

By the end of the first year of the project, we completed the analysis of two key back office operations, Treasury Back Office and Internal Banking Transactions. The results of our analysis were first discussed with the department heads and then communicated to senior management and the members of the coordinating committee. However, many of the recommendations had a major effect on how Aval was currently managed, particularly as to branch operations and the degree to which functions were centralized at the home office. Accordingly, while department managers and the coordinating committee were in general agreement with our recommendations, implementation of the more substantive changes would have required both management changes through Board of Director action and enhanced IT systems. Neither of these components was feasible to achieve during the term of the project. An example of the recommendation format used for Treasury Back Office is attached as Exhibit III.b.

As part of the review of the accounting organization and accounting policies and procedures, we also began assisting Aval in the development of a comprehensive MIS strategic development plan. As stated above, we conducted an assessment of Aval's MIS with respect to its capability to support the transaction level conversion to IAS and the improved accounting procedures and financial reporting. However, in June 1999 the MIS component of the TA program was expanded in response to the need to assist Aval in its overall bank restructure initiatives which were being undertaken pursuant to its commitment letter to NBU. As stated below, the MIS component was further expanded starting October 1999 to include assistance in database and application system design and implementation. In anticipation of the expansion in MIS assistance, the project's MIS advisor performed an on-site evaluation of IBIS, Aval's primary software vender, in Odessa and completed a preliminary Strategic IT Plan. A copy of the final Strategic IT Plan, completed in November 1999, is attached as Exhibit IV.a.

The bulk of the technical assistance at the PARs focused on the preparation of accurate internal financial reports, including the use of proper accounting in the financial records. Therefore, only limited resources were available to advise in the re-organization of the accounting operations and development of revised accounting polices and procedures. In May 1999, both Energobank and Ukrgasprombank prepared proposed organization structures for the accounting and back office functions as a first step in the process of revising the related accounting policies and procedures. We reviewed and made recommendations to senior management on the proposed organization but as of the end of the assistance program for the PARs, none of the proposed changes had been implemented.

Three members of the PIB/PAR group had branches and all three had decentralized accounting systems. It was not feasible within the term of the project to achieve any progress in centralizing accounting functions, even in areas such as fixed assets, which would normally be a "natural" for centralization. The inability to achieve any progress on centralization resulted from both the tradition of decentralized branch management and the lack of resources to make the necessary modifications to the IT systems.

- ***Training, technical analysis, and dissemination of technical materials: No specific benchmarks address training requirements and technical analysis of NBU Directives but on-the-job training, delivery of formal training programs in seminar and workshop formats, commentary on NBU Directives and dissemination of this information are crucial to the accomplishment of the project objectives and are described below***

1) The training program consisting of two-day workshops for the PIB/PAR banks plus the participating bank group (approximately 35 banks) was conducted the joint TA teams of USAID and EU/TACIS. See Exhibit VI for the workshop agendas.

    a) In December 1998, a two-day workshop was developed and delivered to senior management and supervisory staff of the PIB/PAR. This workshop focused on the basic principals of accounting organization, internal audit and internal controls in the accounting procedures.

    b) In March 1999, the second USAID TACIS PAB two-day workshop was delivered to representatives from approximately 30 banks. The first day was devoted to subjects of more interest to senior management and the second day is devoted to technical accounting subjects. The first day featured a presentation by Ivan Voloschuk, Chief Accountant at Aval, covering the factors considered by Aval in reorganizing its accounting and backroom functions. The second day included an introduction to "Barracuda 99", the financial statement software developed by the project in 1998. The presentation featured a "hands-on" practical exercise using six laptop computers.

c) The third joint workshop was delivered on May 26 and 27, 1999. The workshop featured a mock shareholder/analyst conference delivered by representatives from Aval Bank. The presentation materials were prepared by the project team based primarily on Aval's 12/31/98 financial report but the bank was identified only as "Pilot Bank". Also, in order to create an atmosphere of a real shareholder/analyst conference, typical "investor" questions were "planted" in the audience with representatives of the PARs. The purpose of the presentation was to demonstrate how financial information should be communicated to investor/creditor groups in contrast to NBU and management.

2) Sector-wide technical training on specific accounting and internal audit topics.

   a) On June 18-19, 2000 the "pilot" delivery of the computer simulation course, "Realistic Financial Statements" was delivered at the National Center for Training Bank Personnel (NCTBP), the USAID supported training facility jointly operated by the Ukrainian Banker's Association and NBU. This course provided basic, "hands-on" training in the analysis, adjustment and preparation of realistic financial reports using BMRS (also know as "Barracuda"). As further described below, this was one of the two core courses we agreed to develop as part of the sector-wide dissemination program in year two of the project. The primary participants at the pilot delivery were two representatives from each of the PARs. Also, representatives were present from NBU and the British Know How Fund.

   b) In July 1999, the internal audit specialist delivered the course Internal Audit Case Study Course to twenty participants at the NCTBP. This was the initial course delivery at the Center and the program included a morning of introduction by representatives of the Bank Internal Audit Department at NBU. The Center also provided one assistant trainer for the course delivery who would then be qualified to deliver the course in the future. While the course was well received by the participants, we decided to augment the case material with modules on risk assessment and an audit "practice set". This was the second "core" course we agreed to develop as part of the sector-wide dissemination program in year two of the project.

   c) September 23-24, the newly enhanced course on preparing realistic IAS-based financial statements using BMRS, the software developed by the project, was delivered at NCTBP. This course, now called BMRS-Basic, continued as one of the two core courses we are planning to disseminate for broad delivery to the banking sector in year 2000. It was conducted in NCTBP's newly equipped computer training lab and included an introduction by a representative of NBU's accounting reform department. BMRS-Basic also included an in-bank follow-up advisory program that was conducted in year two.

d)

3) Training conducted at Aval.

   a) A formal workshop was delivered to Aval's home office accounting supervisors in the use of the IAS Adjustment Checklist for account analysis and the determination of post-closing entries. The training used the case study method with a practical exercise of sample post-closing adjustments to correct financial statements prepared by BMRS.

   b) In February, a half-day, senior management seminar was conducted at Aval that focused on organizational and procedural imperatives of internal auditing in light of its expanded role. This seminar was specifically designed for delivery to one bank at a time so unique audit issues could be discussed freely. Colin Sutherland, Senior Internal Audit Advisor from the EU/TACIS team, had developed the seminar program and was in attendance at the seminar to assist in its delivery.

   c) In March, the technical audit training program was finalized and delivered to Aval's home office audit supervisors and staff. This training program also used the "case study" method to train in western audit techniques, including risk assessment, system/internal control analysis, audit planning, program preparation, audit procedures and report writing. The case study was prepared using credit "vexels" as the subject audit area. After completion of the training, the IA department, under the guidance of the IA specialist, began planning a "pilot" audit using the techniques covered in the case study.

   d) On June 17-19, the team participated in Aval Bank's Chief Accountant Conference. This conference brought together approximately 90 branch chief accountants for technical training in various NBU instructions and revised Aval procedures. The technical subjects presented to the conference participants by the advisory team are set forth the attached Exhibit VIII.

4) Other dissemination/training programs:

   a) The project website was introduced in January 1999 and allowed for the dissemination, sector-wide, of all technical memorandums, key training presentations and enhancements to BMRS. The website continued active throughout the term of the project and by project-end there were over 1250 inquiries recorded into the website.

   b) On September 27, Mr. Fechtmeyer delivered the introductory presentation on the Principals of IAS at the seminar for supervisory agents from the office of the State Tax Authority (STA). The seminar was conducted at the STA training center in Urpin, Ukraine.

5) Comments were sent to NBU on the following technical directives and accounting instructions:

   a) Accounting for State Bond Conversion (last quarter ’98)
   b) NBU Directive #358-On adjustments to file 02(last quarter ’98)
   c) Accounting and Reporting Policy of Ukrainian Banks(last quarter ’98)
   d) Sample Asset Valuation Policy (first quarter ’99)
   e) NBU Directive #520-Annual Financial Statements of Commercial Banks(first quarter ’99)
   f) Provisioning of Miscellaneous Assets (second quarter ’99)
   g) Directive on Inventory and Low Value Items (second quarter ’99)
   h) Accounting for Credit Transactions (third quarter ’99)

B. Problems:

The principal project objectives were for year one of the project were substantially achieved. All the commercial banks had completed a transaction level conversion to IAS-based accounting and, with the support of NBU, were able to begin the implementation of IAS-compliant accounting policies and procedures and financial reporting. However, accounting system constraints and the lack of resources to purchase/develop and/or install modern bank accounting software continued to impede progress toward full IAS-compliant financial and management reporting. As an example, the system’s inability to retroactively record post-closing corrections resulted in management reports that were not in agreement with the financial records. Also, no significant progress was made on centralizing the accounting function. This resulted both as a result of system limitations as well as the fact that management was decentralized and the accounting systems reflected that organizational structure.

Significant progress was also made in the establishing a sound theoretical foundation for the internal audit function and training senior management on how the internal audit department should be organized to insure its independence. The next step was the implementation of an audit function using SIAS-compliant procedures and the introduction to operational auditing concepts. Implementation in both of these areas needs significant training and the commitment of resources that were not available in the PIB/PAR group during the first year of the project.

C. Results vs. Expected Outcomes as per SOW:

Progress was made on all the Year 1 benchmarks. Those benchmarks where the progress achieved did not meet the level anticipated in the benchmark are as follows:

- The PIB/PAR group did not develop a preliminary set of management reports. Only Aval began the internal programming for preparation of a senior management financial report that included management information.
- As indicated above, no documentable effort was made to centralize the accounting departments.

IV. Year 2 (October 1, 1999 to December 31, 2000):

A. Actions and Accomplishments

The components of the project were modified and redefined beginning October 1, 1999 to coincide with the beginning of bank restructuring program at Aval and the end of the EU/TACIS bank accounting project. The modification divided the project into two major components: The Pilot Bank Program (PIB) and the Sector-wide Dissemination of IAS Implementation Tools (Dissemination Program). The PIB component consisted of in-bank advisory work at Aval and Ukrsibbank, a bank based in Kharkiv that was the largest PAR during the first year of the project. The advisory work at Aval was also expanded to include in-bank assistance in implementing the Strategic IT Plan and providing IT support to the restructure team from Booz-Allen & Hamilton (BAH). The Dissemination Program extended the Kiev-based training programs on IAS and Internal Audit implementation tools into the regions. The training programs focused, in part, on the in-bank use of the Bank Management Reporting System (BMRS), the financial reporting software developed by the project in 1998. A full description of the project modifications and revised benchmarks are set forth in the June 1999 Strategic Work Plan (SWP) attached as Exhibit I.b. The project modifications included an extension through December 31, 2000.

Benchmarks for Quarter One (December 31, 1999):

- ***Aval Bank will have prepared a strategic MIS development plan which includes time line and budget and addresses the priorities at Aval Bank.***

The final Strategic IT Plan was completed after revisions to the July draft plan were agreed to by the IT department at Aval and IBIS, Aval's outside software vendor. This plan still requires that specific application systems be identified for development to support restructuring initiatives. A decision on those applications, therefore, will be made in coordination with the program proposed by the Aval Bank Restructure Project Team consisting of advisors from BAH. Prior to the identification of specific applications for redesign, approximately six months of preliminary work are projected to define the existing data base, run "integrity" tests on the data currently in the data base, complete the new data base redesign, and lay the ground work for preparation of conversion programs. A copy of the final Strategic IT Plan is attached as Exhibit IV.d.

- ***Aval and Ukrsibbank will have developed an IAS-compliant consolidated balance sheet and income statement which is appropriate for internal reporting purposes and will have agreed to prepare these reports monthly starting in year 2000.***

At the meeting of the full coordinating committee conducted in October, Aval made the decision to program its software to prepare the senior management reporting package that we had developed earlier in the year in connection with the "mock" shareholder conference program with EU/TACIS and the PAB group. This package includes condensed income statement and balance sheet plus selected analysis schedules. It is appropriate for dissemination monthly to senior management and members of the Board of Directors because it condenses the information to highlight performance and provides quick comparisons with prior period results. The report is prepared using a newly developed module in BMRS software package. We used that module to prepare the reporting package for Aval's 2nd and 3rd quarters and comparative October and November monthly reports in order to reinforce the in-house use of the reporting format. A sample copy of the reporting package using "Test Bank" data is included in Exhibits VIII.a and VII.c, BMRS User Manual and BMRS Advanced Course respectfully.

Aval's decision to devote the resources necessary to prepare this report on their own system is encouraging as this is the first bank we have worked with that is willing to make that effort and use the BMRS reporting format as the basic monthly reporting. Following that decision, agreement was reached at Aval on both the form and content of the monthly reporting package, and we were advised that it would be scheduled for implementation in January 2000. Aval is having IBIS develop the software to produce the report from its financial records even though most of the report can be prepared using BMRS. We considered the decision to produce the reports with in-house software to be very important, however, since resources to support BMRS after the project was over would be limited and extracting the information directly from the financial records will give Aval more flexibility in future modifications.

An on-site advisory visit was made to Ukrsibbank in Kharkiv in late October to review 3rd quarter financial results. Prior to the visit, the bank had prepared its initial third quarter report using BMRS and had attempted to do the required analysis of selected balances and identify correcting entries as per the IAS Adjustment Checklist. We reviewed the results with accounting management and recommended certain corrections. In particular, we reviewed the system and procedures for determining taxable income for the period. Using the Ukrsibbank system, we assisted the bank's accounting staff in the reconciliation of book income to tax income and the determination of the related deferred tax adjustment. The systems required for this process are new and the effect the reconciliation has on the financial records is not understood by any of the banks we have worked with. Accordingly, the Ukrsibbank model was standardized used for training at Aval. It was also added as a module in the BMRS Basic course was given to USAID advisors to the State Tax Department and the advisory team for enterprise accounting reform.

As of the end of this quarter, Ukrsibbank had not committed to prepare the IAS compliant balance sheet and income statements monthly in 2000. We plan to readdress this issue during the first quarter.

- ***Aval will have developed one new management report from the list of recommended management reports and will have agreed to prepare this report on a sustained basis starting in year 2000.***

During this quarter, Aval did not agreed on which new management reports they would commit to develop for implementation in 2000 except for the senior management reporting package discussed above. Although that package contains supporting schedules which are "management reports", we have recommended additional reports which would improve the information flow to operating management and facilitate their day to day decision making. The methodology and reporting departments at Aval dedicated significant resources to the discussion and design of the monthly reporting package during the last quarter of 1999. Also, the head of the reporting department was transferred to a branch during the quarter. However, we continued to press for a decision on new management reports during the first quarter of 2000.

- ***Aval will have prepared an Internal Audit schedule for 2000 based on a risk assessment of key operational areas.***

During reporting quarter, advisory efforts in the internal audit area at Aval continued to focus on completion of a reportable portion of the "pilot audit" in the Plastic Card Department. Because of the newness of the audit approach, the complexity of the plastic card operations, and the large number of exceptions noted in the department's merchant procedures (approximately 30% exception rate on the sample examined), it was slow going. However, it was important that senior management be advised, on a timely basis, of the interim results because of the problems revealed to date. Accordingly, fieldwork was suspended in late November in order to summarize the interim results and prepare the report for senior management.

We continued to advise Aval's IA department that all components of the plastic card audit should be completed and, during the quarter, we provided audit programs for merchant activity and cardholder activity, and an internal control checklist covering procedures in merchant activity. The audit programs require that the terms and transactions for a sample of merchants and cardholders be confirmed directly with the customer. This standard procedure, which is new to IA procedures in Ukraine, was a subject of much discussion and was not approved by senior management until late in the quarter. As a result, the confirmation procedure was deferred so the audit supervisor could prepare the interim report. The complete audit program and supporting software for sample selection were refined later in the project by an IT audit specialist and are included as Exhibit V.b.

We met with the head of the Internal Audit department in late November to reemphasize the need to perform a risk assessment of key audit areas in order to prepare a risk-based audit plan for 2000. However, by the end of the quarter, this procedure had not yet been started since the department was busy completing the audit reports for all the audits performed during the last half of 1999. The department head has agreed to readdress this process during the first quarter of 2000 based on the methodology we had used in the internal audit training delivered last summer.

- ***Dissemination Program: While no specific benchmarks were set-forth during the first quarter regarding the Dissemination Program, the following summary of activities related to this component were conducted during the quarter:***

1. During our visit to Kharkiv, we met with Olga Moskova, a professional accounting and auditing trainer, and Oleg Vasygenk, Director of the Banking and Finance Department at the National Economic University, to evaluate the feasibility of disseminating the two core

implementation courses in the Kharkiv region as set-forth in the SWP. Ms. Moskova is developing an accounting and auditing training center with the support of the municipality and EUTACIS as part of the "Kharkiv Initiative Program". The University had just begun its Banking and Training Department. Therefore, both resources were very receptive to our proposal. Follow up was conducted at both of these centers during the first half of 2000.

2. The in-bank follow-on visits for the banks participating in the September BMRS-Basic course delivered at the NCTBP in Kiev were conducted by Dick Thorsen, a volunteer advisor from FSVC. The response to the follow-on program was disappointing. Of the 10 banks participating in the course, only three met the requirements for the follow-on visit. Three other banks said they would meet the requirements but failed to do so during the period of the advisor's visit. The other four banks were not interested. On the "plus" side, the banks that were ready for the advisor's visit were the larger banks of the group and their use of the course program in their banks was very positive. We discovered in later quarters that the banks participating in the training were very reluctant to take advantage of the follow-no visits either because of data security issues or lack of time available for implementation of the new financial reporting.

3. The Internal Audit Case Study course was expanded to include a "practice set". The practice set was based on the materials presented in the case study and, by using artificial working papers and documents, required that the students perform the procedures set forth in the audit program. The revised course was delivered at the NCTBP. Sixteen participants attended the course representing 12 banks, NBU and a university. An in-bank follow-up component was also made available but, for reasons similar to our experience with the BMRS-Basic course, none of the course participants requested the follow-on consultation. A computer disc with the complete course and instructor guide is attached as Exhibit VII.a.

Benchmarks for Quarter Two (March 31, 2000):

- *An MIS development plan for Aval Bank which includes time line and budget and addresses the priorities at Aval Bank will have been agreed to. A team on IT specialists at Aval Bank with responsibility for implementation will be identified.*

The final Strategic IT Plan was approved by Aval last quarter (reference is made to Exhibit IV.a). Responsibility for its implementation was delegated almost entirely to IBIS, the outside software supplier. Therefore, there is no team of specialists inside Aval that will monitor performance against the plan. While we recommended stronger internal oversight, the present structure is typical of the Aval/IBIS relationship and Aval did not believe further oversight was necessary.

On February 9, the first, year 2000 coordinating meeting with IBIS was conducted. Progress in the design and implementation of the new data base was slightly ahead of the schedule set out in the Strategic IT Plan and the early identification of new application systems was encouraging (A memo summarizing the IBIS meeting is attached as Exhibit IV.b. It was also clear at that meeting that IBIS was proceeding rapidly with the new data base modifications and that they were technically competent to complete this task without continual monitoring from an on-site

IT advisor. According, upon consultation with the bank restructure team from BAH and the USAID project officer, the scope of work for the MIS component of the project was modified. The role of the on-site IT advisor was eliminated and more resources were allocated to assistance with application design for management reporting and restructure support. A copy of the changes to the scope of work is attached as Exhibit IV.c.

In preparation for the completion of the new database, the project's IT advisor began organizing the information on the existing database to develop a schematic diagram of the system and a comprehensive cross-index of data base tables and fields. This information is in both Ukrainian and English so that data fields needed to support application systems can be readily identified by the advisor working on the specific applications. At the end of the quarter, IBIS provided us with the technical framework of the new data base system and work on the translation of that information was begun.

- ***Aval will have developed one additional management report from the list of recommended management reports and will have agreed to prepare this report on a sustained basis.***

Progress on the identification and development of improved management reporting was slow. The list of internal reports prepared by Aval in January still contained many of the old reports that we had recommended be eliminated and did not include the monthly senior management reporting package which had been agreed to last quarter for implementation monthly starting in January 2000. Aval confirmed that it was still in the process of programming its internal systems to prepare this report. However, this task was not completed by the end of the quarter. Accordingly, during the first quarter of 2000, senior management was not given IAS-compliant balance sheets and income statements.

In order to assist Aval in its evaluation of current management reports and to illustrate reporting areas to prioritize for future management reporting, we used the BMRS daily funds flow module to estimate the effectiveness of treasury operations. This relatively simple procedure provided an approximation of non-invested funds both daily and, on average, for three 10-day periods. The periods used coincided with the reporting to NBU on statutory reserve levels. The result of the test indicated that there were potentially significant non-invested funds and therefore lost revenue. A report on this test was sent to senior management but, as of the end of the quarter, there has been no reaction to the test results.

During meetings with the head of the department of financial analysis and the meeting of the coordinating committee which was conducted at the end of the quarter, Aval made the decision to develop a maturity gap report and an interest rate sensitivity report during the 2nd and 3d quarters. The design and programming needed to automate the preparation of these reports required the assistance of an IT specialist. In the quarter ended September 30, 2000 the IT specialist assisted Aval in identifying data base components and modifications needed to facilitate the preparation of the reports on a bi-weekly basis. A copy of his report, including the design components of the report is attached as Exhibit V.c.

- ***Ukrsibbank will have developed one new management report from the list of recommended management reports and will have agreed to prepare this report on a sustained basis.***

During the quarter, Ukrsibbank did not yet decide to prepare a monthly, internal IAS-compliant financial report or a management report. On February 14 and 15, the team visited the bank in Kharkiv and provided assistance in the preparation of its 1999 financial report using BMRS. We also assisted the bank in completing the condensed senior management financial reporting package in the format used at Aval.

Since the beginning of our work with Ukrsibbank in early 1999, the bank had been a consistent user of BMRS within the accounting department. However, this information was apparently not being disseminated and used by senior management. As of the end of the quarter, the coordinating group had not committed to train staff to complete the condensed senior management reporting package that we had recommended. They also had not provided us with their list of management reports to review and analyze so we could recommend the additional reports, if any, to develop. At the same time, in our meeting with Oleg Moiceenko, Deputy Director and project coordinator in Ukrsibbank, we agreed on the goals for our TA during 2000 which included a focus on implementing improved internal financial and management reporting.

- ***BMRS will be modified for year 2000 changes to the NBU instructions/COA and enhanced to include selected management reports***

BMRS 2000 (nicknamed "Storm") was introduced in late February in the BMRS Basic course held at the National Center for Training Bank Personnel (NCTBP). BMRS 2000 is a significantly enhanced version of the Barracuda software used in 1999. It not only incorporates changes in the NBU instructions and chart of accounts, but programming improvements were made that make it easier to use and provide more flexibility in report preparation. As of the end of the quarter, the management report components of BMRS were still under development. During the quarter, eighteen banks requested and were given copies of BMRS 2000.

- ***A survey of potential sites for two other regional training facilities will have been completed and an evaluation made as which, if any, of the surveyed sites have the computer and trainer capability to deliver the implementation workshops.***

In February 2000, the advisory team made a follow-up visit to Kharkiv for the purpose of evaluating whether the new International Consulting Center (ICC) facilities could support the administration and delivery of the core courses. This evaluation included the capability of the center's computer lab to support delivery of BMRS-Basic and BMRS-Advanced. We concluded that the ICC had adequate facilities to deliver the core courses and made arrangements with the center's director to deliver BMRS-Basic and the Internal Audit Case Study Course in March. As part of our evaluation of ICC and the region's commitment to the accounting transition, Mr. Fechtmeyer and Boris von Hoffmann, USAID Senior Banking Advisor, met with the Head of the regional NBU and the Vice-Governor of the regional government. Both agency officials were very supportive of ICC's goals and our participation in the center's programs.

Even though we had agree to deliver the BMRS-Basic course, response to the course solicitation was disappointing with only two registrations received. Accordingly, the BMRS-Basic course was cancelled and only the Internal Audit Case Study course was delivered.

Inquiries were also been made in Odessa to locate a training facility there. By the end of the quarter, discussions had been held with the Chief Accountant of the regional NBU, Pivdeniy Bank (they claimed to have an adequate computer lab), and the National Economic University. NCTBP has proposed administering the training programs in Odessa. However, as explained below, we were not satisfied with our experience with the NCTBP on the "training the trainer" aspects of the program for the BMRS-Basic we did not accept that proposal. While we believe that Odessa is the next most significant region after Kharkiv for expanding the delivery of the courses we were unable to find a suitable training facility in that region.

- ***The NCTBP will have completed the training the trainer program for the BMRS Basic and the Internal Audit Case Study Workshops and be capable of delivering these courses on a sustained basis, including post-course follow-up advise/visit.***

On February 24-25, the BMRS-Basic course was delivered at the NCTBP. Twenty-three participants, representing 16 banks, successfully completed the course that was "team-taught" by the project's foreign advisor as well as the project's Ukrainian accounting professionals. All banks participating in the course were given a copy of BMRS-2000 (Training Version) on CD-ROM for installation at the banks. Also, a letter was sent to the bank chairman advising him/her that the software had been furnished and that, as a follow up to the course, the participant had been asked to use the program in the bank to prepare the IAS-compliant financial reports. The letter also stated that advisors would be available to visit the banks should the bank wish additional assistance with implementation of the procedures.

NCTPB did not schedule the Internal Audit Case Study Course during the quarter but, as stated above, it was delivered at the ICC in Kharkiv.

The training the trainer component of the training program in the core courses did not develop to the point that we believe was needed to give the initial centers the ability to deliver these courses on a sustained basis. Neither of the two training assistants provided by the NCTBP as future trainers for the BMRS-Basic would be capable of delivering the course effectively. They were not sufficiently trained in IAS nor did they have the practical bank experience to be effective trainers to a participant group that already has significant hands-on experience. In hindsight, the course may be too technical to use the "train the trainer" concept which is more adaptable at the introductory level. Similarly, the assistant trainer selected by the ICC for the Internal Audit Case study course did not have sufficient internal audit experience to deliver that course in the foreseeable future. At the same time, there were selected participants in both courses that appeared qualified to be future trainers if available. As a result of our experience in NCTPB and the ICC in Kharkiv, we decided to deliver the courses to university professors and advanced students as an extension of the dissemination program. The professor group could be more appropriate for future trainers.

- ***Follow-up advisory services and/or site visits will have been conducted by the project instructor and training assistant for a majority of the banks represented in the core courses delivered at NCTBP by the project advisor***

The follow-up advisory program for both the BMRS-Basic and Internal Audit Case Study courses is well below expectations. In late January, after the holiday season, participants in the November internal audit course at NCTBP were contacted. None of the participants had the time to complete the in-bank implementation assignment from the course and none were available for further assistance.

The follow-up program for the February BMRS-Basic course produced equally disappointing results. The availability of the follow-up program was communicated by letter to the bank CEO upon the participant's completion of the course. About three weeks later, each CEO was contacted by phone. Several could not "remember" the first letter so a second letter was sent. Other CEOs claimed they already had adequate internal reporting so BMRS and our further assistance wasn't needed. To those CEO's getting a second letter, another follow-up phone call was made and the response was generally that the need for in-bank assistance was "under consideration".

Both of the core courses were developed in response to the need to provide practical training in procedures that can actually be used in the bank. The courses are well received by the participants and have the full support of NBU. In fact, during the quarter, meetings were held with Ms. Rychakivska, Chief Accountant of the NBU, and Mr. Politiva, Head of NBU's Internal Audit Department, to insure their on-going support of the program and coordination of our training with NBU's efforts. Also, the participants in the BMRS-Basic course were interested in taking the BMRS-Advanced course scheduled to be introduced in the third quarter. Ironically, several of the BMRS users, including Credit Swiss First Boston, were from the interbank lending departments and they were using BMRS to evaluate the credit worthiness of other Ukrainian banks. Yet, the banks were not using the program their own internal reporting.

- ***Aval will have prepared an Internal Audit schedule for 2000 based on a risk assessment of key operational areas.***

Aval's internal audit group prepared its audit schedule for the first six months of 2000 but did not completed the risk assessment despite their continued commitment to do so. Therefore, the audit schedule does not properly address the areas of risk. As an example, branches are scheduled for audit based solely on the date of the last audit rather than deposit size, level of risk assets, results of last audit, etc. During the quarter we retrained internal audit management in the risk assessment methodology that was part of our course last summer. We then identified the operating areas within the home office that needed a risk assessment as a guide for that internal audit unit to begin. For the branch internal audit department, we developed a statistical scoring system based on individual branch financial data to give that unit a "start" to the assessment process.

Aval's internal audit department has been slow in implementing the audit planning and procedural changes that we have been training them in for the last year. The pilot audit program initially used in plastic card operations was continually delayed because the only auditor assigned was frequently re-assigned to temporary duties. In discussing this issue with senior management, they expressed full support for our program. During the quarter, a new director of internal audit, Igor Savelievich, was appointed. Igor begun working regularly with our internal audit advisor to push for completion of these past tasks. He has also agreed with us that, as a condition to continuing with the pilot audit program, a team of auditors must be assigned and that team will be under our supervision for the period that it takes to complete the designated pilot audit.

Benchmarks for Quarter Three (June 30, 2000):

- ***Aval bank will have begun implementation of its MIS data base redesign.***

The November 1999 revision of the IT Strategic Plan called for the conversion of the database to be completed on or about September 20, 2000. By the end of this quarter, representatives from both Aval Bank and IBIS were still declaring that date to be valid. However, as we were to learn in the following quarter, the new data base system was not implemented and the first set of applications (Dealing, client bank, general ledger functions, operating day, and basic financial reports) was not converted to run against the new data base system. Further, field-testing of some of these applications was recently begun in the Chernigiv branch but the testing is being conducted in support of "limited operations" units of the branch, not the entire branch. Our review and verification of the test results is reported upon in the next quarter.

In the head office, synchronization of the old and new systems with existing data, estimated to begin in March, had not been implemented by the end of the quarter. The significance of this is that while the new data base is operational, the additional data fields, many of which are required to support improved IAS financial and management reporting, were not populated with data. We were advised that problems came up in the new data base implementation and conversion at the head office and, as a result, performance against the strategic plan was delayed. Aval management was aware of the slippage and took action to correct the situation. They made the decision to develop the enhanced applications in-house using Aval IT staff instead of leaving that task with IBIS as originally planned. We were told that that decision would allow IBIS to increase the resources allocated to continuing data base development and conversion.

A fundamental assumption of the strategic plan was that IBIS would upgrade and develop new application systems and that no significant development would be undertaken in-house. Since Aval has assumed this task, its IT technicians and system users would have to acquire knowledge and experience in system development in the technical environment created by IBIS before they can become as efficient as IBIS technicians. Therefore, further delays in the implementation schedule set forth in the strategic plan were certain to result.

It should also be recognized that Aval's decision to move application development in-house restricted the ability to disseminate the results of our technical assistance and Aval's experience throughout the banking sector. With Aval's application systems being developed internally it will be even more proprietary than if it had been developed by a third party (IBIS) who would have a vested interest in marketing a superior product to the banks.

The following planned sequence of application development continued to reflect the business priorities of Aval.

1. Dealing (sic), client bank, general ledger module (new), and financial performance – basic financial reports, currently being tested in the Chernigiv branch
2. Plastic card operations, including security, card issuance, and direct links to the new consolidated database for on-line analytical accounting and management reporting.
3. Revised and upgraded personnel and payroll systems.
4. Centralized fixed assets and tax accounting.
5. Securities trading and accounting (deferred until later in the year).
6. Profitability of bank instruments (*not* profit centers).

Our IT technical assistance program conducted after this quarter, provided assistance in various aspects of systems covered in 1, 2, and 5 above.

During the quarter, a thorough translation and analysis of the new data base design, including a comparison with the existing system, was completed. The new database is far larger and more complex than the old. Many new data fields and refinements of access security have been added, and the ability of users to add new data fields to tables improved. IBIS's design approach is sound, and appropriate for a software house developing a generic product useful across the banking sector. However it is more complicated than it needs to be except for all but the very largest full service banks. Therefore, its application to the banking sector as a whole will be limited.

- ***The BMRS--Advanced Workshop will be developed.***

The development of the BMRS Advanced Workshop was not completed until the following quarter as the management reporting enhancements to the revised BMRS software program ("Storm"), which underlie this workshop, were still in process at quarter end. However the workshop format and the "mock" data files that will be used in the workshop (approximately a dozen data files in the NBU format) were completed.

- ***The NCBT will have completed the train the trainer program for BMRS Advanced and be capable of delivering the two core implementation courses and the advanced course***.

As stated above, development of the BMRS Advanced Workshop was not completed until next quarter. With regards to the "training the trainer" component of the two project core courses, as discussed earlier in this report, NCTBP was not successful in establishing a sustainable trainer cadre for the courses. As an example, on April 17-18 we delivered the Internal Audit Case Study Course at the NCTBP but an assistant trainer was not provided. This was the third time the course had been delivered at the NCTBP and an assistant trainer was provided for only one of the course deliveries. On the other hand, the NCTBP does have the complete instructor guides for the two core courses. During the quarter, they conducted a workshop specifically for Aval's IA department and used elements of the project's Internal Audit Case Study course as part of the materials for that workshop. Accordingly, some components of the core courses are adaptable and are being used to disseminate technical training by the NCTBP.

Because of the difficulties experienced in developing a sustainable training program at NCTBP as well as the International Consulting Center in Kharkiv (ICC), we decided to explore using the university sector as the sustaining training resource. The universities have permanent faculty and they could offer the courses both as part of the normal curriculum and/or in an extension program to working students.

After consultation with USAID, on April 24-25, the BMRS-Basic course was delivered to eleven faculty members of the Banking Department at the National Economic University in Kharkiv (NEUK).

- ***One regional center will have completed the training the trainer program for the BMRS Basic and the Internal Audit Case Study Workshops and be capable of delivering these two courses on a sustained basis.***

The comments on the previous benchmark address in part the difficulties in establishing a sustainable training facility for the core courses in the Kharkiv region. Because our experience with ICC and the faculty of the National Economic University, in June 2000 we met with the director of Banking College of Kharkiv (BCK). BCK has as a separate Bank Training Institute (BTI) that is supported by the regional NBU. This center provides permanent faculty and computer labs for sustainability as part of BCK and an outreach program to the banks through the BTI. The directors of both the college and institute were very receptive to incorporating the two core courses into their programs and both courses were delivered to bank participants and faculty (future trainers) during the next quarter.

On June 26-27, 2000 members of the team traveled to Lviv, Ukraine to meet with representatives of the Banking College in that city. The organization in Lviv was similar to the BCK in Kharkiv, as there is a separate Banking Institute supported by NBU attached to the college. Again, the centers in Lviv provide both the permanent faculty and computer lab necessary to establish a sustainable program and the respective directors were enthusiastic about being able to offer the courses. Delivery of both courses was conducted during the next quarter.

In addition to the training centers in Kharkiv and Lviv, in June, we met with the heads of the Banking Department and IT Department at the National Economic University of Kiev to discuss the project's software, BMRS, and our core courses. This meeting was followed by an on-site demonstration of BMRS and installation of the program in the IT Department laboratory.

- ***Follow-up advisory services and/or site visits will be conducted by the project instructor and training assistant for a majority of the banks represented in the course delivered by the project advisor at the regional center.***

As stated previously in this report, there has been no demand for in-bank follow-up advisory services, which is part of the two core courses, despite the fact that follow-up letters and phone calls are sent reminding the course participants of this service.

Benchmarks for Quarter Four and to Project Close (November 15, 2000):

- ***At Aval Bank implementation of the MIS development plan will be well in progress on at least one sub-system to be specified in the workplan which promote bank restructuring objectives (for example the policies and procedures for a redesigned credit administration).***

As described in the previous quarter, problems came up in the new data base implementation and conversion at the head office and performance against the strategic plan was delayed. Aval management was aware of the slippage and took action to correct the situation. They made the decision to develop the enhanced applications in-house using Aval IT staff instead of leaving that task with IBIS as originally planned. In that way, we were advised that IBIS could increase the resources allocated to continuing data base development and conversion. We were also advised that the first set of applications (Dealing, client bank, general ledger functions, operating day, and basic financial reports) have been converted to run against the new data base system and that field testing of these applications was begun in the Chernigiv branch.

The short-term IT advisors that were working with Aval during the quarter in evaluating the new deposit and plastic card application system and developing the gap management reports confirmed that the slippage in implementing the IT strategic plan was continuing. Contrary to what we were told in June, the new database is not populated with data and was not being used by Aval even though its design was completed in the spring. Therefore, the automated maturity and interest sensitivity gap reports had to be based on the limited data that could be extracted from the old database.

The IT advisor evaluating the new customer deposit/plastic card application system being developed in-house, which is called “Robin”, spent two days in Chernigiv where the new application system is being field tested. His conclusion from that evaluation was that Robin was a very elementary branch banking system that lacked basic customer and deposit functionality. The advisor also raised general concern on the overall process and documentation standards in the in-house development effort. His report on this system is attached as Exhibit V.a.

The IT advisor who assisted Aval in the development of the IT Strategic Plan met with Yakiv Smoliy, Deputy Director and head of IT at Aval, to assess status of the plan. The earlier findings reported by the project’s IT specialists were confirmed. Basically, the design of the new database is completed but it is not being used to support new application systems. The timing for populating and using the database is uncertain. IBIS continues to provide on-going maintenance support to Aval but is no longer doing development work.

The IT staff at Aval was strengthened with the addition of four new technical staff to support new application design. However, the bank has experienced explosive growth since the beginning of the year (60% increase in transaction volume) so new application design efforts often take a "back seat" to immediate needs. Management of Aval believes the bank benefited from the formal planning exercise we introduced as part of the discussion and design of the IT Strategic Plan. But, there has been no new plan developed to replace the original plan which, under current circumstances, is not on hold. A report on the status of the IT Strategic Plan and related recommendations is attached as Exhibit IV.d.

As part of the IT support to the bank restructure team, an IT specialist assisted the newly formed MIS group within the credit department with designing credit reports and identifying the appropriate fields within the database where information could be extracted to prepare the reports. A copy of the IT specialists report, Credit Administration Reporting, is attached as Exhibit V.d.

- ***Aval bank will have completed the revision of its accounting policies and procedures at the home office and such revised polices and procedures will be in substantial compliance with IAS.***

In September, Aval completed the fourth and final (for year 2000) revision of its complete set of technological cards (TC) which represent the banks formal accounting policies and procedures. We had reviewed key drafts of TCs during the year and our comments were incorporated into the final version. The TCs, as revised, are in substantial compliance with IAS. However, the final TC manual does not contain certain TCs that would be needed for Aval to have fully compliant IAS financial records and reporting. In all cases the omitted TCs are in areas were the NBU has not yet issued instruction. Examples of such areas are consolidation, deferred tax accounting, and recognition and measurement of financial instruments (IAS 39).

In addition, we had previously noted that the general process of preparing TCs was making the task more difficult and that our memorandums on the specific TCs reviewed were repeating many of the same basic deficiencies. Accordingly, we prepared a model TC for management to consider in preparing TCs in the future. Aval's methodology department prepared one TC using many of our recommended changes to the content and format. The revised, "model" TC was given to us late in the quarter further review and discussion. We are optimistic that many of the features in the model TC will be adopted in future TC revisions. A copy of the model TC using interest accrual as an example is attached as Exhibit III.c.

- ***Aval bank will have completed a majority of the internal audits scheduled for the first six months of 2000 and these audits will have been performed in compliance with ISIA. There will be evidence that management is implementing corrections in response to audit deficiencies.***

For the most part Aval Bank has followed its audit schedule for the first six months of 2000. For branch audits, only one branch audit was delayed by one week. Two head office audits were not completed. The audit of "Transactions with Funds Raised at and Placed with the Interbank

Market" was cancelled and replaced with another urgent audit request by management and the audit of "export-import Transactions, Settlements via Documentary LC's" was delayed due to illness. The head office audit department stills follows Aval's previous system and has not fully adopted international standards of internal auditing to their auditing procedures. However, based on our prior audit training at Aval, some improvements have been adopted. Sampling is now used in some cases, the department is preparing more detailed audit programs, and flow charting of procedures is being attempted.

The branch "pilot" audit, which was done under our supervision, was completed at the end of June 2000 so did not yet have an effect on the branch audit methodology for the first half of the year. However, we noted that subsequent branch audits are much closer to international standards of internal auditing. Significantly, improvements were noted in documenting the review of internal controls and in distinguishing between the roles of the internal auditor, external auditor, and the 'revision' function. It is now the branch audit section's current practice to review the flowcharts that were drawn up in the pilot audit and to complete the internal control questionnaires. Although, the audit programs are sometimes not followed in their entirety due to the extra time required, much more detailed instructions are now given by the supervisors to their staff. Unfortunately, although everyone agreed that the pilot audit documentation was much better, the current documentation procedures have not changed significantly, again probably due to the extra time required. There is a good chance that this latter point will be rectified when the external auditors start to review the internal auditor's working papers.

Aval does have a very strict system of follow-up on audit findings. Upper management is involved and management of the audited department is expected to respond promptly to the internal audit's management explaining in writing what steps it has taken to correct deficiencies noted. If necessary, the audit department performs a follow-up review.

- ***Aval will have adjusted its financial records to comply with the audited external financial statements issued as of December 31, 1999.***

Senior management of Aval made the decision not to adjust its financial records to comply with the "Big 5" external audit report and not to publish IAS-compliant financial statements, which would differ from those previously presented to its shareholders and NBU. Accordingly, the financial records of the bank, the reports to NBU and financial information furnished to shareholders and the Ukrainian public do not comply with IAS. Early in the year, management had agreed to do this and it was part of Aval's commitment letter to NBU. Therefore, we had included full IAS compliance as a key benchmark for the final quarter of the project.

Management's reasons for not making these adjustments were: (a) NBU did not provide instructions on how these adjustments were to be reported, (b) there was no agreement on the period of time that resulting capital shortfalls could be recovered, and (c) the adverse client reaction and public opinion could jeopardize the bank's market position and liquidity.

There is justification for management's decision in this regard. A major directive issued by NBU this year was the requirement to publish financial reports by July 1 accompanied by the auditors' report. The initial draft of the directive required that the audit report be from an "internationally recognized" firm. However, that requirement was challenged and was not in the final directive. The banking sector was effectively "off the hook" on its IAS reporting obligation. Therefore Aval and, from our observation, probably most other banks accompanied their published financial statements with a local, statutory audit report which was not IAS-based. NBU did not achieve the sector-wide compliance for the IAS-compliant reporting that would be needed to protect the individual banks reporting adjusted results. A translated memo from Aval management on the IAS adjustment issue is attached as Exhibit III.d.

- ***A third training facility will be identified and have completed the training the trainer program for the two core implementation workshops and be capable of delivering these courses on a sustained basis.***

By the end of September, three bank-training institutes had completed the training the trainer program for the two core courses, BMRS-Basic and the Internal Audit Case Study course. The NCTBP in Kiev completed the program last quarter, and, as previously reported, we were not confident then that the center had developed the trainer capability to continue delivery. However, they have been furnished soft and hard copies of all the course material and related software. They also maintain an aggressive training program for bankers and, although the project's specific training courses are not currently offered, components of these courses are included in the NCTBP's programs.

In September 2000, both the BMRS-Basic and the Internal Audit Case Study courses were delivered at the Lviv center. The Banking College furnished two faculty members to be assistant trainers in the course and a full set of course materials and related software were provided to allow for incorporation of the courses into the curriculum for both the Institute and Banking College.

In Kharkiv, which had been identified as the region for our second training center, the BMRS-Basic course was delivered in July at the Kharkiv Bank Training Center and the Internal Audit Case Study Course was delivered in September. Assistant trainers were provided from the College faculty and the course materials and related software were given to the Institute for follow-up training.

As a further effort to expand the dissemination of the core courses and at the request of the regional NBU in Odessa, the BMRS-Basic and Internal Audit Case Study courses were delivered in Odessa during July 2000. Participants in the courses included representations from commercial banks as well as the regional NBU and the National Economic University. The training facility used was provided by IBIS, the Odessa-based software supplier for Aval. Unfortunately, we were not been able to locate a training center in Odessa that had the computer laboratory and staff capable of delivering these courses on a sustained basis. However, the Odessa participants and NBU were very interested in the courses and appreciative of the opportunity to participate in the training in their region.

- ***The BMRS--Advanced Workshop will be developed.***

Development of the BMRS Advanced Workshop was completed concurrent with finalization of the management reporting enhancements to the revised BMRS software program ("Storm"). The concept of the workshop was discussed with Vera Rychakivska, Chief Accountant at NBU, and Directors of the bank training centers in Kiev (NCTBP), Kharkiv and Lviv. The course offerings ere originally scheduled at the NCTBP and Lviv for delivery in October 2000 but publication of the scheduled times was delayed and there was insufficient response. Accordingly, the delivery was re-scheduled for the NBU training center in Kiev and twenty-three participants were given the two-day workshop. A copy of the instructor guide to the course is attached as Exhibit VII.c.
The BMRS-Advance course is linked to two key components of the sector-wide dissemination program, the training program itself and making available, through the website and in-bank visits, enhanced software for preparation of IAS-compatible financial and management reports. We have observed that, even three years into the IAS-based accounting reform process, the banks are still not preparing suitable, IAS-compatible internal financial and management reports and there is no software product that is readily available to Ukrainian banks for this purpose. Accordingly, with the encouragement of NBU, other bank advisors, and the BMRS-Basic course participants, we devoted significant resources to the development of BMRS-Advanced and the dissemination program.

In order to maximize the potential for dissemination of the software product, we prepared the BMRS User Manual and Tutorial that included detailed installation and statement preparation instructions together with the software on a CD-ROM. The tutorial section of the manual consisted of key components of the BMRS-Advanced course and the NBU data files for "Test Bank" which were created for the course. This will enable the recipient of the manual to practice with the software by preparing reports for Test Bank.

Two departments in Aval had already been supplied with the manual and trained to use the software. To facilitate expanding its use sector-wide, we designed a one-day, in-bank workshop and offered this to the other banks in the EU/TACIS restructure project and selected larger banks. During November 2000, five in-bank workshops were conducted at the following banks: Ukraina, EnergoBank, VaBank, Forum, and Ukrsibbank.

A copy of the BMRS User Manual and Tutorial, together with a list of software users as of the project close are attached as Exhibit VIII.

- ***The NCTBP will have completed the train the trainer program for BMRS Advanced and be capable of delivering the two core implementation courses and the advanced course.***

As of the end of the project, the BMRS-Advanced course had not been delivered at the NCTBP. However, Instructor and Student guides for the course, together with all supporting software were furnished to NCTBP, the NBU bank training center in Kiev, and the training centers in Kharkiv and Lviv.

- ***Follow-up advisory services and/or site visits will be conducted by the project instructor and training assistant for a majority of the banks represented in the course delivered by the project advisor at the regional center.***

As stated previously in this report, there has been no demand for in-bank follow-up advisory services.

B. Problems

Year two of the project attempted an acceleration in the efforts to enhance the management control systems (MCS) operating within the PIBs and, through the dissemination program, within the entire banking sector. It was an aggressive program that required the banks to allocate significant resources to the meeting the objectives. However, the banks had already extended significant efforts to accomplish the conversion to the new chart of accounts, revisions to NBU reporting, and modifications to accounting policies and procedures to comply with IAS and NBU directives. It was understandable therefore that senior management was reluctant to commit the resources needed to accomplish all phases of the program. This was also evident system-wide by the switch of donor resources (EU/TACIS and British Know How Fund) from bank accounting reform to bank restructure and, as stated in the report above, the relative inactivity of the accounting reform staff at the NBU.

The content of the "stage two" training program (post-theoretical to an implementation focus), which was the foundation of the two core courses and the BMRS-Advanced course presented a challenge for the training the trainer concept. Trainers needed to be competent practitioners with "hands-on" experience in using the course material in order to be effective trainers. It also required a "workshop" approach to training which was a change from the traditional lecture method common in the delivery of theoretically based courses. Therefore, although course trainers were trained in three centers around Ukraine, their effectiveness was not demonstrated prior to the close of the project.

C. Results vs. Expected Outcomes as per SOW

The PIB components of the SOW had four principal objectives: Fully IAS-compliant financial reporting by Aval, progress in implementing improved MIS systems at Aval, improvements to management reporting at Aval and Ukrsibbank, and development of an improved internal audit function at Aval. The results that did not meet the expected outcomes are as follows:

- Aval did not adjust its financial records to agree with the external, "Big 5" audit report so it is still not preparing IAS-compliant reports to NBU, in is locally published report, or to its shareholders.
- The database at Aval was redesigned but the new database has not been implemented and there was no significant progress made on developing new application systems.
- No demonstrated improvement was made in the financial and management reporting at Ukrsibbank although intensive, in-bank training just prior to project close may result in improvements in this area.

As stated in the above section on problems in the dissemination program, the demand for in-bank follow up visits to the two core courses was disappointing. A large part of the concern by bank management centered on security issues. However, as part of the rollout of BMRS-Advanced, intensive one-day, in-bank workshops were conducted which were attended by representatives from senior management. Security of bank data was not a problem because "Test Bank" data was used.
The reasons for the departure from expected results are discussed in detail in the above report.

V. Role of and Coordination with Other Donors or International Financial Organizations:

In addition to the joint PAB seminars conducted during the first year of the project with the EU/TACIS team, the following are examples of other coordination efforts with other donor projects and international financial organizations:

- In fall 1998, support was rendered to several "Big Bank" examination teams that were in Ukraine as part of the IMF bank evaluation project. Specifically, several teams received copies of BMRS and were trained in its use in order to facilitate the preparation of IAS formatted financial reports and general financial analysis.
- In December, 1998 Mr. Fechtmeyer delivered a presentation, "IAS Conversion in the Banking Sector of Ukraine, The Reform Process and its Significance to Ukrainian Enterprises" at the National IAS Conversion Seminar sponsored by the Central and East European Forum (CEE Forum).
- In fall 1998, the project's IT consulting team assisted the British Know How Fund in developing a test program for the preparation of the year-end cash flow statement using the general programming logic in BMRS
- In February 1999, the combined project update meeting was conducted at NBU with representatives from USAID/TACIS, officials of NBU, representatives from all PIBs and PARs and both advisory teams. The purpose of the meeting was to assess progress in year 2 of the project. In addition Messrs. Fechtmeyer, USAID project team leader, and Kopp, EU/TACIS team leader, were awarded the "Memorial Silver Hryvna Award" in recognition of the projects' contribution to the successful accounting reform in the commerical banks.
- In spring 1999, two joint programs were developed with FSVC to deliver training in Statistical Sampling in Auditing and Risk Management in FX Operations. The audit training was suggested by the project's IA specialist and gained the enthusiastic support of the IA group at NBU.
- In February 1999, the team advisors met with Bruno Cornelio, USAID Division Chief for Capital Markets and Banking, to review the results of the project's efforts and discuss specific approaches used successfully in Ukraine to accomplish the project's objectives. One result of the meeting was that we sent copies of the financial statement software programs we developed during 1998 to the newly organized USAID Resource Center in Washington DC so they be more readily available to other contractors working an accounting reform.

- In February 1999, Diana Slobodian, the project's accounting advisor, delivered a presentation on the IAS Framework and Bank Accounting Reform in Ukraine to the American Ukrainian Humanitarian University Forum.
- In March 1999, Diana Slobodian and Dmitri Shkolnikov attended the two-day, All-Ukrainian Conference on Accounting Reform in Ukraine. Although largely devoted to enterprise accounting reform, presentations were delivered by NBU representatives regarding bank accounting reform.
- In April 1999, Gary Fechtmeyer and Yakiv Smoliy, Deputy Chairman of Aval Bank, were interviewed by the "Kompanion" Business magazine about the USAID sponsored technical assistance at Aval.
- In May 1999, Gary Fechtmeyer meet with the training advisors from the British Know How Fund to update them on the focus of IAS training to date and future training needs for the purpose of the developing the British Know How Fund's 1999/00 training program.
- On May 28, Gary Fechtmeyer was interviewed by Roman Vosolskiy, reporter for the Eastern Economist, for an article in that magazine on IAS accounting reform in Ukrainian banks.
- In June 1999, Diana Slobodian participated with the advisor team in the NBU Supervision Department in presenting a workshop on "Adjustments to Miscellaneous. Assets" at NCTBP.
- In June 1999, Gary Fechtmeyer delivered a presentation at the Annual Conference for Financial Analyst on the need for curriculum focused on IAS accounting in the Ukrainian University system.
- On July 7-9, Gary Fechtmeyer attended the Regional Bank Supervisors Conference in Sofia, Bulgaria and led a "break out" session on the use of external audit reports in the supervisory function.
- In October 1999, The Bank Restructure Project under BAH and the related MIS Expansion component, which is part of the IBTCI project, began. During that month, several introductory meetings were conducted to introduce the combined restructure and MIS team to representatives of World Bank and IMF. These meeting included the "kick-off" meeting for the project that was conducted at NBU. Alexander Kyreyev, Vice Governor of NBU, chaired the meeting, which was attended by the members of the USAID Restructure/MIS team, the USAID Bank Accounting Reform; the other three EU/TACIS restructure teams, and representatives from USAID, World Bank, EU/TACIS, and IMF.
- In October 1999, Gary Fechtmeyer met with Remi Duflot and Jean-Luc Poget, Managing Director of Euro-Ukrainian Consulting, to discuss our cooperation in bank training efforts with the EU/TACIS sponsored Kharkiv Initiative program.
- In November 1999, Gary Fechtmeyer met with representatives of World Bank, the USAID Enterprise Accounting Reform Project and the Consortium for Enhancement of Ukrainian Management Education (CEUME) to coordinate efforts for accounting curriculum development in the Ukrainian Universities.
- In January 2000, Gary Fechtmeyer met with USAID advisors to the State Tax Administration (STA) and, together with representatives of the USAID Enterprise Accounting Reform Project, developed a joint program for delivery of IAS training to STA officials.
- At the request of USAID, Gary Fechtmeyer and Bruce Johnston developed a program for a general diagnostic of the status of IAS accounting and MIS capability in the commercial banking sector for use in other countries of the FSU.

- In March 2000, the project team and representatives from USAID met with a delegation of community and business leaders from Kharkiv to present the project's goals in disseminating training for the benefit of that region.
- In March 2000, Gary Fechtmeyer participated in the USAID sponsored workshop covering national accounting reform in other countries of the FSU.
- In April and June 2000, representatives from the project team met with Stuart Ferency, USAID project officer for the Kharkiv Initiative Program, to discuss further cooperation with that program and the training and in-bank advisory efforts of the project in Kharkiv.
- During the period May 1 to May 15, 2000, Gary Fechtmeyer conducted a diagnostic review of the status of the conversion to IAS by the commercial banks in Georgia.
- In July 2000, Gary Fechtmeyer attended the Regional Bank Supervision Conference in Warsaw, Poland.
- In September 2000, Mr. Fechtmeyer spoke on the status of IAS compliance in the baning sector at a planning meeting of the Chief of Parties for the USAID and EU/TACIS bank restructure teams.
- During the term of the project, advisors from the project regularly attend the monthly meetings of donor agency contractors advising Ukraine in the national accounting reform effort.
- Upon the close of the project, the projects technical implementation tools and training programs were disseminated to the following (see Exhibit IX for the distribution schedule) **–**

  - USAID
  - EU/TACIS Bank Restructure Coordinator
  - NBU Supervision, Internal Audit and Training Departments
  - Bank training centers in Kiev, Kharkiv, and Lviv.

VI. Other Relevant Issues

Description of any particular issue(s) that may have arisen in the course of project implementation that was not originally anticipated. Any deviation from the SOW, etc.

Since the project was a follow-on to the previous project that introduced IAS-based accounting and reporting to the banking sector, it was an opportunity to test many of the tools and techniques available to enhance the banks' management control systems. Many of these control systems are common-place in a modern banking environment so it is tempting to assume that these "best practices" would be readily acceptable to management of the Ukrainian Banks thereby facilitating their implementation. In reality, common practices such as centralization of the accounting and treasury functions and maintaining the reporting independence of the internal audit department represent major departures from existing management practices and require lengthy deliberation. Even a straightforward redesign of internal financial reports at Aval to be IAS-compatible required Board of Director approval. Accordingly, the time required for acceptance needs to be factored into the implementation timeline in order to establish more realistic benchmarks.

The above issue is further aggravated by the sheer number of advisors in the key banks. At Aval, there were two resident, USAID advisor teams. In addition, there were frequent visits by IMF and EBRD advisors. At two of the PARs, EBRD advisor teams were present in addition to the project team. The teams coordinated their activities on a regular basis. However, The banks just do not have the resources either in personnel or IT systems to understand, evaluate, and implement the large volume of changes proposed by the various advisor teams.

Training in the second-stage or implementation phase needs to be brought into the banks wherever possible since this is the best way to actually test applying the training experience to the work environment. The in-bank follow on program which was promoted as part of the two core course was not well received by the banks, probably because of security and staff availability issues. However, the in-bank workshops used to rollout the BMRS-Advanced course were well received and even attracted senior managers. Participation by senior managers, which is critical to acceptance of the training message, was never achieved in the prior classroom sessions for the core courses. Further, effective training in this implementation phase needs to be country/industry specific. This limits the effectivness or any "of-the-shelf" training materials.

VII. Conclusions

Description of the overall conduct of the Task Order and the results achieved. Any major lessons learned and ideas on how to formulate similar projects that can avoid encountering the problems faced in the implementation of this Task Order.

During the two years of the project, there was significant progress made in the quality of financial reporting from many of the banks in Ukraine. The sector wide financial information being used by NBU in its regulatory function also improved substantially. It is important to note that during the initial conversion period (1/1/98 to 9/30/98) the new reporting was largely a "mechanical" process with little, if any, improvement in the quality of the numbers reported. This follow-on project spanned the period that introduced substantive changes to the financial reporting, particularly in the loan loss provisioning and other asset valuations. It is noteworthy that, in early 2000, NBU issued the new requirement that all banks publish their financial reports in a condensed, but IAS-compatible, format. These reports also had to be accompanied by a report of the external auditor. While not IAS-compliant for the reasons previously stated, the publishing requirement was a major step forward in forcing transparent reporting from the banking sector.

Full IAS compliance was hampered by the lag in national accounting reform. Early in the project there was a concern that the banking sector was proceeding ahead of national accounting reform and that one or the other would have to either "catch up" or lag. The National Accounting Law was effective 1/1/00 and bank accounting had to comply with the National Accounting Standards (NAS). As a result, during year 2000 key NBU directives that were needed to establish proper accounting for income taxes, consolidation, and reporting results of operations were never issued because NBU was waiting for the relevant NAS.

The accounting transition remains a work-in-progress until full IAS compliance is achieved. The technical knowledge to complete that part of the reform process is substantially present within the accounting practitioners. Senior management, however, has to have the will to accept the adverse financial consequences of compliance and NBU needs to address the phase-in rules. The more difficult component is the need for further enhancements of the management control systems to a level which even approaches a modern banking system. This requires additional technical and resource support. Key factors that continue to impede progress in this area are:

- The continued lack of understanding by senior management of the need for improved financial and management reporting.

- Insufficient financial resources in the banks to make the necessary enhancements to their IT systems. Three years after conversion, BMRS continues as the only local software that can efficiently prepare IAS-compatible financial reports.

- The need for additional internal audit personnel and intensive, practical training in internal audit procedures. The shortage of qualified internal auditors is aggravated by the lack of an auditing profession that understands ISA-compliant procedures.